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THE UNIVERSITY OF ALBERTA

Northland Bank: An Historical and Organizational Perspective

By

Brian S. Hunt

A THESIS

SUBMITTED TO THE FACULTY OF GRADUATE STUDIES AND RESEARCH IN PARTIAL FULFILMENT OF THE REQUIREMENTS FOR THE DEGREE OF MASTERS OF BUSINESS ADMINISTRATION.

FACULTY OF BUSINESS

EDMONTON, ALBERTA

SPRING 1989

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Northland Bank:
An Historical and Organizational
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submitted by Brian S. Hunt in partial fulfillment of the degree of Masters of Business Administration.

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Date: Feb. 3, 1989

ABSTRACT

This paper examines the formation, evolution and demise of Northland Bank. The rationale for the creation of the Bank, the objectives of the founders, and the strategies and organizational structure by which the Bank hoped to achieve the original objectives are considered.

Over its ten year history, the Bank had four changes of President and pursued many different strategies in trying, at first, to be profitable and, later, to survive. The paper outlines and evaluates changes in management, strategies and organizational structure caused initially by demands of the Bank's Board of Directors and later (and more dramatically) by changes in the economic environment of Western Canada.

The bail-out attempt of the Canadian Commercial Bank (CCB) had a severe negative effect on Northland. The confidence of the public, regulators, government and the other chartered banks was severely weakened. The changes of the attitudes of the regulators, the reductions in the amounts of wholesale deposits and the withdrawal of credit by other Canadian Banks are also discussed.

The Bank was allowed to continue to operate after becoming technically insolvent due to "system tolerance".

The roles of management, the Board of Directors, the Auditors, the Office of the Inspector General of Banks and the government and their respective contributions to system tolerance are also examined.

Due to the failed bail-out attempt of the (CCB) and perhaps due to initiatives of the government to increased competition in the banking industry, the CCB and Northland were permitted to fail rather than being absorbed by another financial institution as had been the tradition in Canada since 1923.

The original concept for the formation of the Bank was based more on a perceived, rather than actual, need for a Western Canadian bank to service the commercial middle market. The structure of Northland Bank made it vulnerable to the cyclical nature of the Western, resource based, economy and neither the organizational structure of the Bank nor its management were capable of overcoming the problems of the economic environment caused by the severe recession of the early 1980's.

Preface

The issues surrounding the liquidation of the Northland Bank and the Canadian Commercial Bank are highly controversial and political. Many legal issues remain unresolved and substantial lawsuits have been filed in both instances. In the case of the Northland Bank, two lawsuits were filed in early 1987 and served in August, 1988 by Northland Bank and Touche Ross Limited, in its capacity as Liquidator of Northland Bank and by Canadian Deposit Insurance Corporation and her Majesty the Queen in the Right of Canada, as Represented by the Minister of Finance claiming damages in the amount $480 million and $650 million, respectively. In the case of the Canadian Commercial Bank at least one law suit has been commenced, filed and served by Canadian Commercial Bank (in Liquidation) and Price Waterhouse Limited, in its capacity as Liquidator of Canadian Commercial Bank, claiming damages in the amount of $294 million.

Much of the information obtained for this paper was obtained through personal interviews with a number of former officers and employees of Northland. Due to the outstanding lawsuits which name a large number of officers and Directors of the banks, where requested, anonymity was assured to those interviewed. Where permission was granted by the interviewee, I have indicated the source of opinions or statements, but I have not been able to state the source in a number of instances. As a result, these comments are credited generically, for example, "an officer of Northland Bank stated...", to provide the required confidentiality.

The reader may also find it helpful to know that the writer was employed by Ellesmere Developments Ltd., Epicon Properties Inc., Northland Bank, and ultimately, Touche Ross Limited, liquidator of Northland Bank. Many of the opinions and comments relating to the situations and strategies of the Northland are based upon that experience. Although I have strived to maintain an objective viewpoint, some subjectivity may have inadvertently been retained.

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Introduction

On September 1, 1985, in a move unprecedented in Canadian banking history, the Department of Finance, announced that Touche Ross Limited had been appointed curator of Northland Bank ("Northland" or "the Bank") and that Price Waterhouse had been appointed liquidator of Canadian Commercial Bank ("CCB"). In a press statement released the same day, the Governor of the Bank of Canada, Gerald K. Bouey, stated that he had received notification from the Inspector General of Banks, William Kennett, that Northland and CCB could no longer be considered viable entities (see Appendix I). In that same announcement, Bouey stated that the Bank of Canada had been providing liquidity support for both institutions and as a result of the conclusion of the Inspector General, there was no basis for providing further support and, accordingly, it was being withdrawn.

The announcement stunned both the financial community and the general public. There had not been a bank failure in Canada since the closing of the Home Bank of Canada in 1923. Although between 1923 and 1985 eleven chartered banks had been relatively quietly merged into other banks and a number of trust and finance companies had failed or been forced to merge with other institutions, the widespread perception was that Canadian banks could not fail (1).

The appointment of a liquidator of CCB came in the wake of a bailout attempt which had been made in March of 1985. The rescue package, which had been hastily organized by the federal government and included a number of banks and governments, had been inadequate or ineffective. The very fact that external support had been required had, however, foreshadowed the failure announcement.

The appointment of the curator at Northland was unexpected and created confusion for both the Bank and the public. Although prior to the appointment of the curator it was widely known that the Bank had been relying heavily on liquidity support from the Bank of Canada, assurances had been issued by Northland, William Kennett, the Inspector General of Banking, and Lou Hyndman, the Treasurer of the Province of Alberta, that the Bank was not in serious trouble. In July of 1985, Kennett had stated that he was confident that Northland would be "able to mend itself because it has good management that is trying to diversify it's (sic) deposit base" (2) and Hyndman had backed up the claims of Northland management that the Bank was solvent, stating that, "There is every indication of stability." (3).

Never before had the provisions of the Bank Act which authorize the appointment of a curator been used. No one, including the curator, Touche Ross Limited, completely understood the powers, responsibilities and potential liabilities of this position at the time of the appointment. The Bank had lost its funding support from the Bank of Canada and yet it was directed to carry on in the normal course of business under the "supervision" of the curator while an attempt was made to either reorganize the Bank or locate a merger partner.

In a letter dated September 27, 1985 to the Minister of State for Finance, Barbara McDougall, and the Inspector General of Banks, William Kennett, Touche Ross Limited advised that:

> We believe that a full understanding of the circumstances under which the affairs of Northland have reached the current state cannot be obtained in the absence of enquiries beyond the function and power of a curator appointed under the Bank Act. We do not suggest that we have seen any evidence of wrongdoing, only that it appears to us that it may be considered appropriate to make such enquiries.

As a result of the recommendation of the curator and in response to the demands by the opposition parties to an investigation into the failures of both CCB and Northland by a committee of the House of Commons, the Honourable Willard Z. Estey ("Estey"), Justice of the Supreme Court of

Canada, was appointed to conduct an inquiry into the affairs of the banks by an Order in Council dated September 29, 1985. His mandate was "to inquire into and report on the state of affairs surrounding the cessation of operations of the Canadian Commercial Bank and the Northland Bank, and to make any consequential recommendations for changes in the control of the banking industry in Canada....". (4)

The findings of Mr. Justice Estey were published in August of 1986. The inquiry required 75 days of hearings during which time a total of 85 witnesses and submissions were considered. The facts and conclusions contained in the report are a distillation of 75 volumes of transcripts containing in excess of 13,500 pages.

Notwithstanding the comprehensiveness of the Estey Report, the writer has utilized primary sources such as annual reports, press releases and original letters and reports for information and data wherever possible even where similar information was presented by Estey. In a number of instances, there are discrepancies between both the data and conclusions of the report and other sources such as annual reports and information obtained from interviews with former Bank officers.

This paper traces the history of the Bank from its modest beginnings in Western Canada to its well-publicized curatorship and ultimate liquidation. Also examined are the economic and political environments and the successes and failures of management in coping with the forces that impacted upon the creation and evolution of the Bank. Was the failure of Northland Bank the result of an ill-conceived concept that was doomed to fail from its inception or was Northland an unfortunate victim of a uniquely disastrous combination of external shocks and internal problems that could not have been foreseen or thwarted, even by the most prudent of management? How did the Bank survive as long as it did only to be placed in curatorship in 1985 and in liquidation in 1986? Was the rescue attempt commenced by management in 1983 realistic or was it ill-fated and implemented at additional cost to previous investors and to those new investors who contributed new capital on the strength of the apparent turnaround?

CHAPTER ONE

The Formation of Northland Bank

This chapter traces the origins of the Northland Bank by examining its founders and their perceptions, the environment and the reasons for the Bank's creation. The proposed goals and objectives, and the strategies and methods by which those objectives were to be achieved, are also considered to assist in evaluating whether the proposal to create a Western Canadian bank was fundamentally sound or whether it was a blueprint for failure.

Obtaining the Charter

Background

In June, 1973, the four Western premiers met in Calgary at the Western Economic Opportunities Conference. At the conference, they expressed their dissatisfaction with banking service in the West by issuing a joint statement which stated, in part, that:

> The oligopolistic position of the Canadian chartered banks results in higher interest rates than are justified, a more conservative lending attitude, and less flexibility. The branch banking system, characterized by the major Canadian chartered banks with branches coast-to-coast and

> head offices in Central Canada, has not been adequately responsive to Western needs. (1)

The widespread view at that time was that the Eastern based institutions discriminated against the West in their lending practices. The perception of a need for Western regional financial institutions was shared by both the private and public sectors. (2)

In response to this perceived need, the government of British Columbia created British Columbia Savings and Trust in 1975. Although labelled a trust company in the enabling legislation to avoid the applicable prohibitions of the federal Bank Act, the institution was intended to provide banking, insurance and trust functions. (3) According to David Barrett, the Premier of the New Democratic Party government of British Columbia:

> Rural and northern regions have a difficult time getting funds, compared to Central Canada or metropolitan areas. Small businessmen and farmers have more difficulty obtaining loans than do multinational or eastern-based corporations. (4)

The effort to create British Columbia Savings and Trust was made in spite of the existence of the Bank of British Columbia which had been chartered in 1966 and had commenced operation in 1968. (5) Whether due to its relatively small size or the limited range of services provided, both the Government and the private sector perceived a need (or an opportunity) for the formation of another Western Canadian based bank with its head office in Vancouver.

The founders of the Canadian Commercial and Industrial Bank ("Industrial" was later dropped) had originally chosen Vancouver for its head office but had ultimately selected Edmonton in response to the plans to create British Columbia Savings and Trust Corporation. (6) This "super bank" was never launched, however, as a result of the defeat of the New Democratic Party and the election of a Social Credit government in December of 1975. (7)

The initiatives of the private sector resulted in the formation of both CCB, which received its charter on June 12, 1975 and, subsequently, Northland. The target market for Canadian Commercial Bank (CCB) was the middle market (loans of approximately $200,000 to $3,000,000) in Western Canada, which was perceived to be inadequately serviced by the large Eastern-based banks. (8) It was felt that the Big Five: The Royal Bank of Canada, Bank of Montreal, The Canadian Imperial Bank of Commerce, Toronto-Dominion Bank, and Bank of Nova Scotia, were not providing adequate banking services to the smaller and more entrepreneurial businesses in the West.

CCB

The formation of Canadian Commercial Bank resulted from a concept developed by Boyd, Stott & McDonald ("BSM"), a merchant banking affiliate of Morguard Trust Company. (9) The primary target market was junior, privately owned, companies in the real estate, wholesale and energy industries. (10) The concept was to fund the bank through wholesale deposits rather than establishing a retail branch network and to engage in entrepreneurial lending. (11) According to the Estey report, "The proposed bank was intended to be an aggressive, low-overhead bank responding to the needs of smaller businesses and not one which would engage in direct competition with the major banks.". (12)

The founders believed that the Big Five were hampered by the structural impediments of operating a massive branch system which required them to provide a full range of services to an extremely diverse customer base. (13) In the study commissioned by BSM, a former economic advisor to the Bank of Montreal was quoted as stating that:

> The heavy investment of most of the banks in extensive branch systems has locked them into the position of serving as many of the financial needs of Canadians as possible, in order to enhance the return of these extensive fixed capital assets. (14)

It was felt that economic opportunity existed in the niche business that the Big Five could not, or would not, service. (15).

The bank was expected to engage in merchant banking activities (which Estey defines as activities that generate fee income in addition to interest income (16)) and higher risk loans. During the debates in the Senate prior to the approval of the charter, the founders were even complimented for their "courage" in planning to operate on such a basis. (17) In order to minimize some of the risk associated with Western regional concentration such as loan quality and economic cycles, the founders of CCB stated from the outset that they were ultimately seeking to establish a "national bank with offices in all the provinces ....". (18)

The Founders of Northland Bank

In 1972, a Task Force on a Financial Facility was struck by a group of Western co-operative corporations to consider the viability of a Western regional bank. The initiative resulted from the perception that there were financing needs in the region which were not being serviced by the co-operative credit societies and the provincially-based central credit unions. (19) It was believed that a significant opportunity existed in the middle market which required larger and more sophisticated loans than were available through the co-operative system. Additionally, the concept was for the proposed bank to take advantage of the excess liquidity which existed in the co-operative and credit union systems. (20)

To better evaluate the market and its needs, the co-op group, through Allan Wagar, Chief Executive Officer of one of the prairie co-operative insurance corporations, retained the services of Robert A. Willson. Willson was intrigued by the prospect of a co-operative based bank that would be able to capitalize on the existing liquidity and client base of the co-operative system so he agreed to act as a consultant to the Task Force to assist in determining the feasibility of such an institution. (21)

Willson was the founder and president of Willson Associates Limited, an international consulting company which had been formed in 1961. The firm was headquartered in Calgary and was active both across Canada and internationally. It had previously provided consulting service to Mid-west American banks and had a working familiarity with two British institutions which were similar to the Canadian co-operatives, the Co-operative Holding Society and the Co-operative Bank. Subsequently, through his international connections, Willson was also introduced to successful co-operative banks in France and West Germany.(22)

The mandate given to Willson was to review and assess the information and data compiled by the Task Force, determine the steps required to apply for a bank charter, and assess the political situation for expected opposition or resistance to an application. He enlisted the assistance of Alan Scarth, Q.C., who had been acting as counsel to the Task Force, to assist in investigating the bureaucratic hurdles and assessing the political climate. (23) This mandate did not include any quantitative assessment of the market demand for the services to be provided by the bank; the task force (and, apparently, Willson) had concluded that the bank was wanted and needed. As in the case of the CCB, a significant weight seemed to have been placed upon the fact that, in spite of a large number of Big Five branches in the West, "... the proprietors of small and medium-sized businesses, especially in Western Canada, had long complained that it was difficult if not impossible to obtain the kind of financing they needed from the banks." (24)

Willson's preliminary investigations resulted in the discovery that there was a serious problem with the proposal to obtain a charter for a co-operative bank. The Bank Act prohibited any shareholding greater than ten percent and the perception of the politicians and regulators was that the proposed founding co-operatives would be acting as a single entity. (25) This perception was reinforced by an initiative of some prairie credit unions which occurred at approximately the same time. They had determined that the national body, the Canadian Co-operative Credit Society, should be converted to a national liquidity manager for the credit unions. This proposal significantly weakened the argument that the proposed bank would be owned by autonomous shareholders.

The concern over the ten percent shareholding limit, however, was the only significant issue raised by the government. (26) To address this concern, the model of the proposed bank was altered to provide for significant ownership by individual co-operatives, but with a considerable proportion of the shares to be widely distributed to the public.

In his investigations, Willson surveyed the finance critics of the opposition parties as well as the finance ministry and in every instance met with general support and approval for the proposal. (27) According to Willson, they received a very warm welcome in Ottawa. In fact, John Turner, then the Minister of Finance, had previously prepared draft legislation which would have permitted provincial banking. (28) This draft legislation had been prepared in response to the Western Economic Opportunities Conference in 1973. This legislation was never enacted but it indicated a predisposition in favor of the concept of regional banking.

Background Research

Included as part of the research which was conducted prior to the development of the actual bank model was a survey of Western businessmen to determine the nature of the market and the viability of the proposed bank. The strongly prevailing view was that the Eastern banks were not adequately servicing the Western provinces. (29) Numerous examples of lengthly delays in processing loan applications were cited.

In contrast, the businessmen gave numerous examples of "suitcase bankers", representatives of American and European banks, who travelled to the West on a "trapline" basis and would often approve loan applications immediately. Similar loan applications would often take many weeks or months to be approved by members of the Big Five. (30) The delays in the approval system were attributed to the unwieldy and lengthy chains of command in the Big Five and the fact that the ultimate decision-making authorities typically resided in Toronto or Montreal. (31) The consensus was that the Canadian banks were not particulary interested in providing competitive banking services to Western Canada, preferring to concentrate on the markets of Ontario and Quebec. (32)

It is interesting to note that neither the task force nor Willson felt it necessary to conduct any quantitative analysis of banking activity in Western Canada. The perception that bank service was inadequate was considered to be sufficient justification for the formation of a Western regional bank. (33) Although the focus was slightly different, in a study concluded in 1978 by John N. Benson of The Fraser Institute, it was concluded that, contrary to the widespread belief that banking discrimination existed in different regions in Canada (which belief had been the cause of the efforts to create the aforementioned British Columbia Savings and Trust), regional discrimination did not exist in banking in British Columbia (34).

The Proposal for Northland Bank

In a document entitled Proposal to Establish a New Canadian Bank: Northland Bank, the promoters specified the goals, objectives and stategies of the proposed institution and set out the needs and opportunities for a western based regional banking facility. According to the proposal, the concept of forming a bank was the result of an increased awareness by co-operative societies and credit unions of a need for financings in agribusiness, production, retailing and insurance which exceeded their resources. (35) "Exhaustive research" had established that a need existed for the establishment of a Western-based banking facility which would operate in Manitoba, Saskatchewan and Alberta and would provide businesses with "operating capital and term loans, assist in the creation of a western money market and the attracting of new investment." (36).

As set out in the proposal, the principal strategies of the bank were to be as follows:

1. Provide business in Manitoba, Saskatchewan and Alberta with operating capital and term loans, in keeping with region (sic) conditions and needs.

2. Assist in the creation of a Western Canadian money market and attraction of new investment.

3. Within carefully defined corporate guidelines for policy and review, give to each branch manager sufficient credit granting discretion to enhance speed of decisions locally.

4. Encourage a process of enlisting advice and interest from representatives of each community in which the bank will have an operation.

5. Minimize emphasis upon the aggregation of personal chequing and savings deposits as a source of funds. Emphasize the skill of the Bank's corporate management in purchasing short and long term domestic and international funds at favourable rates in the money market.

6. Emphasize financial and management counsel to principals of client entities as a prime service feature.

7. Secure and maintain managerial competence and experience to serve natural resources, secondary industry, commerce and agribusiness with sufficient skill as to earn client respect.

8. Secure direct access to international loans and foreign exchange services through correspondent

> relationships with certain significant offshore and U.S. banking institutions, to enhance service to domestic clients.
>
> 9. Be unusually diligent in tight control of adminstrative, organizational and other overhead costs to offset an initial advantage larger competitors may enjoy in their ability to purchase cheaper money. (37)

Although the concepts for the formation of CCB and Northland were remarkably similar, the desire to create a national bank was not shared by the founders of Northland Bank.

Capitalization

One half of the initial capital of $10,000,000 was to be raised through the sale of shares to the ten prairie co-operatives. To allay the concerns of the regulators with respect to concentrated ownership, the balance of the shares were to be widely distributed in Alberta, Saskatchewan and Manitoba. Original subscribers acquired 473,360 shares and an additional 385,640 shares were sold through a private placement in August of 1976. (38)

Northland Bank was incorporated by the passage of a Special Act of Parliament which received Royal Assent on December 20, 1975. There was considerable support for the passage of the bill: it required only six weeks from the time of its introduction to the House of Commons to become law. (39) In contrast, the attempt to form the Bank of

Western Canada (which never actually commenced operations), was delayed for two and one-half years from its first application to the granting of its charter in 1966. (40) Upon receiving the approval of the Governor-in-Council of Canada, Northland Bank opened for business on September 28, 1976. (41)

CHAPTER TWO

The Early Years - 1975-1979

This chapter examines the management, objectives, lending, and operating results of Northland during the early years of operation.

Headquarters

The original plan had been to have the Bank's headquarters in Winnipeg, but the task force ultimately decided that Alberta offered better opportunity than Manitoba and Calgary was selected. (1) The titular head office remained in Winnipeg, however, in recognition of the credit unions from Manitoba which had initiated the idea for the Bank. (2) Initially, the bank was headquartered in the offices of Willson Associates Limited in Calgary. In early 1976, the bank moved to new offices in Bow Valley Square. At that time, Willson was appointed Chairman of the Board, a position which he initially occupied on a part-time basis. He retained an office and remained active with his consulting firm during the early stages of the bank's development.

Hiring a President

As the Bank Act requires the appointment of a Chairman of the Board, President, and Chief Financial Officer, one of the first tasks of the founding group was to appoint or hire individuals to fill these positions. Robert Willson was asked to chair a provisional committee responsible for recruiting a President. (3)

The initial choice for President was G. Howard Eaton who was to act as a consultant to the co-operative task force and to assist with the development of the conceptual plan for Northland. (4) Willson had located Eaton in his search for an experienced banker to assist with the analysis of the "shortcomings" and "lack of service" of the Big Five in Western Canada (5). Eaton had been recommended by Albert Hall, former Chairman of the Bank of British Columbia (6) and had agreed to be a consultant to the task force on the promise of receiving the presidency if the bank was successfully launched. (7)

In March 1975 Eaton departed the Northland project to join forces with William McDonald and Michael Boyd in the attempt to form what would become CCB. (8) Eaton ultimately became the first President and Chief Operating Officer of CCB and later gained noteriety for, among other things, moving to Santa Barbara, California, while still President and CEO to lead the CCB's expansion into the

United States.(9)

Although there is no evidence that Eaton made any meaningful contribution to the assessment of the market (especially given the nature and extent of the evaluation actually conducted), as the prospective President, his departure was a serious set-back to the effort. The founders delayed the application for a charter until a president could be found. (10) Locating a replacement for Eaton proved to be a difficult task. In his book Breaking the Banks, Arthur Johnson wrote that "Willson..., had admitted in an interview in May 1975 that the search for a chief executive officer was not going well." (11)

After interviewing numerous senior bankers from both Canadian and American banks, the job of President was offered to Hugh Wilson. Wilson had extensive banking experience in both domestic and international lending. He had been employed by both the Toronto Dominion Bank and the Rainier Bank of Seattle in their international divisions (12). He also had branch office experience in Western Canada (13). Hugh Wilson's lifelong involvement with banking and well-developed analytical skills proved attractive to the recruiting committee. (14) In late 1975, Hugh Wilson joined the bank as its first President and Chief Executive Officer.

The Board of Directors

The initial share issue attracted approximately 400 shareholders. The co-operatives and credit unions subscribed to approximately 50% of the issue, Deutsche Genossenschaftsbank (DG Bank) of Frankfurt, 5% and the governments of the provinces of Saskatchewan and Manitoba, 2.5% each. The balance of the shares were widely distributed, primarily in Western Canada. The initial Board of Directors was composed largely of representatives of the co-operatives and credit unions, reflecting the large percentage of shares held by those organizations.

As reported in the first annual report of the Bank in 1977, nine of the fourteen founding Directors were leaders of major credit unions or co-operatives in Western Canada, two were "business and community leaders" in the local market and one was the Chief Operating Officer of a European bank. (15) The two other Directors were Robert Willson, as Chairman, and Hugh Wilson, as President ("double L" and "single L" Wilson respectively as they were commonly referred to). Some of the Directors had been members of the original task force set up by the credit unions central and the major co-operatives.

As set out in the Chairman's address to the shareholders in the 1977 annual report, the Board of

Directors took an active role in the early management of the Bank. (16) With regard to the Directors, Willson stated that "All are participating in the establishment of Bank priorities, and in endorsing major operating policies." (17) Willson perceived his own role as a combination of diplomat, regulator and consultant: "My preoccupation as Chairman is to bring Board and management together in common cause, assure adherence to guiding principles, and assist senior management wherever appropriate.". (18)

Early Lending

As a result of President Wilson's international lending background and contacts, much of the bank's early business was concentrated in international lending. Under Wilson's guidance, the bank participated heavily in syndicated sovereign loans which provided a better interest spread than domestic lending at that time. (19) In January 1979, the bank went so far as to be the lead lender of a syndicated loan of $US 10,000,000 although the loan was syndicated only to existing shareholders of the Bank (20). Because of Wilson's contacts, Northland had no difficulty obtaining funding from the wholesale money markets through major investment houses.

Hugh Wilson took the position that seeking funds from the wholesale markets was less expensive than raising monies from the retail market. Utilizing the wholesale market rather than emphasizing retail deposits was consistent with the original proposal to create the Bank. By participating in syndicated international loans wherein the bank acquired portions of loans from other lead lenders, the Bank realized excellent spread income while maintaining relatively low administration costs. Unfortunately for Wilson, the Board of the bank did not share his enthusiasm (or in the words of one former officer, Wilson's "intense pre-occupation") for international lending, which reached nearly 50% of the loan portfolio in the early years. (21)

Hugh Wilson was responsible for creating the initial credit approval system. At the time of its implementation, Chairman Willson was impressed with the inquiry process required by the system. (22) According to Willson, the bank focused on cashflow rather than asset based lending. (23) This lending philosophy was also endorsed by Peter Saunderson, who was promoted to Vice-President Credit in 1980. (24)

Firing a President

Hugh Wilson was terminated by the Bank on July 27, 1979. (25) In his report, Estey refers only to the reasons for termination set out in the minutes of the Board of Directors meeting at which Wilson was dismissed. (26) The formal grounds for dismissal were described in the minutes of the Board as "deficiences in interpersonal skills." (27) which had resulted in a deterioration of the relationships between Wilson and other "members of the senior management team". (28) There was also growing criticism of Wilson's management of personnel. (29) It was thought that Wilson was not providing adequate leadership and that this was hurting morale. (30)

According to former Northland officers, the emphasis on international lending was a significant contributing factor to the Board's growing dissatisfaction with Wilson. (31) Although the bank was operating profitably, Wilson refused to adhere to the "guiding principals" set forth in the original proposal and this was not acceptable to the Board.

Wilson and the Board did not work well together. (32) This conflict may have arisen because a significant portion of the Board came from credit unions and co-operatives where the Boards of Directors were very active in both operations and policy formation. In contrast, Wilson's experience had been with larger institutions with more remote Boards which were much less actively involved with the ongoing operation of the business.

In any event, the board was concerned that the Bank was not fulfilling its original mandate to develop a domestic loan portfolio, that Wilson was difficult for them to deal with, and that there was growing unrest among key officers and staff of the Bank. (33) According to a former officer of the Bank, efforts were made by the Board to accomodate Wilson by leaving him in charge of international lending and appointing a new President whose mandate would be to fulfill the original objectives of the Bank and serve the Western Canadian domestic market. (34) This would have required Wilson to give up the Presidency and this was unacceptable to him. (35) Wilson commenced an action for wrongful dismissal which necessitated a footnote by the auditors to the financial statements contained in the 1979 annual report relating to the contingent liability. (36)

Results

The underlying objectives of the Bank had not changed since its inception. In the Chairman's Address in the 1978 annual report, Willson stated that "...our originally stated purpose and thirteen guiding principles continue to be valid as a direction finder." (37) He went on to list a number of priorities for the upcoming year, the first of which was to expand the domestic loan portfolio. The renewed emphasis on domestic lending was intended to compensate for Wilson's previous single-minded pursuit of international lending that had been developed almost to the exclusion of domestic lending.

The early successes of Wilson appear to have been acceptable to the Board of the Bank; Northland became established and profitable relatively quickly. However, once the bank became established, the Board refocused its attention on fulfilling the original mandate of the bank: to service the needs of Western Canadian businessmen and develop a domestic loan portfolio based on that objective.

Notwithstanding the dissatisfaction with Wilson, at the time of his departure the Bank was left with a relatively sound loan portfolio. In the final analysis, in the words of a former officer, "Hugh Wilson didn't damage the bank, but he didn't move it ahead". Estey also supports this conclusion: "There is no doubt that in the period ending 1979, apart from its overconcentration in sovereign loans, the position of Northland Bank appeared to be reasonably sound." (38) and: "The annual inspection reports of the OIGB [Office of the Inspector General of Banks] for the years of 1977, 1978, and 1979 reveal that in the early years of the bank, Hugh Wilson had maintained a conservative stance and guided the bank along a path of steady growth.". (39)

At the end of fiscal 1979, the Bank reported assets in the amount of $154,812,513 and loans in the amount of $131,128,790. The loan loss experience was $436,000, or .33% of total loans, up from $35,000 in fiscal 1978. The price per share of the Bank stock ranged from a low of $10.75 in fiscal 1977, to an average of $11.00 in 1978, to a high of $16.00 in 1979, closing out the fiscal year at $14.75. (40)

CHAPTER THREE

1979-1981

This chapter examines the evolution of the goals and objectives of the Northland Bank and the implementation of change under the leadership of Robert A. Willson. The operating results and changes to the Board of Directors are also considered.

R.A. Willson - President

After the departure of Hugh Wilson in July of 1979, Northland's Board requested that Willson assume the duties of President and Chief Executive Officer. Willson had no experience in banking and had not sought the position of President. (1) As reported by Estey, in a message to the shareholders shortly after his appointment as President, Willson stated that,

> While not a banker, I am advised by my fellow Directors [that] the Board's appointment of myself is predicated on my extensive management expertise in Canada and abroad as senior executive, teacher and consultant, including counsel to other banks in the past. (2)

Willson did not have the intention or desire to remain as President. He felt that the Bank "had to have a career banker to do the job properly". (3)

According to Willson, there were three main objectives he was asked to pursue by the Board in his new capacity as President and CEO. His first priority was to aggressively expand business in Western Canada. His second objective was to transform the management team into a closely-knit top quality executive group and his third goal was, as chairman of a small executive committee of the Board, to locate and hire his successor as President and CEO. (4)

In the 1979 annual report, Willson, as Chairman, President and CEO stressed the development of the domestic market and forecast very aggressive growth. (5) He also stated that the basic business plan supported "... our forecast for 1980 of an increase of total assets by 55-60% to approximately $240,000,000 and of balance of revenues before tax by 90-100%, to just under $2,000,000." (6) In that same report, he spoke of the requirement to expand the capital and deposit bases to support the planned growth. (7)

In his report to the shareholders in the 1979 annual report, Eric T. Young, the Senior Vice-President and General Manager, stated that for the year ending 1979, the increase in commercial lending (from $77,000,000 to $124,000,000) had been almost entirely domestic. (8) This was due to a "... calculated management decision to reduce the relationship of non-Canadian dollar lending to total lendings by recognizing that domestic lending should have priority." and because of poor interest margins in international lending. (9) Willson wasted little time in realigning the Bank's objectives after the departure of Hugh Wilson in July of 1979.

Young also commented in his report that the Bank intended to make a "... particular effort to find larger loans and, where these are too large for us to handle alone, then to syndicate them." (10) He did point out, however, that the emphasis was not intended to exclude small and medium-sized loans, as these loans were also part of the Bank's mandate. (11)

Results

Under the leadership of R. A. Willson, the Bank aggressively pursued its mandate to increase its loan portfolio in Western Canada. The real estate and oil and gas sectors of the Western economy were expanding rapidly. The lenders who had previously been accused of ignoring the needs of Western Canadian business were now competing to capture greater shares of the market. Lending was very competitive and the Big Five (amongst others) were aggressively pursuing higher loan volumes, asset growth and increased market share. Northland also focused on this market as being the perfect vehicle by which to pursue the objectives of rapid growth and increasing its activity in Western Canada. With land and oil and gas values rising rapidly, lending in these sectors was viewed as easy and profitable.

Willson succeeded in fulfilling his mandate for growth during his first term as President. The loan portfolio grew very rapidly during 1979 and 1980: from $128,000,000 at the end of fiscal 1979 to $214,000,000 in 1980 and to $400,790,000 by the end of fiscal 1981 (see Appendix II which provides a summary of Northland operating results throughout its history). In addition to overall volume, during 1979 and 1980, the size of the average loan also increased significantly. At the end of fiscal 1979, the average loan size was $317,000 (12) whereas the notes from the inspection by the Office of the Inspector General of Banks (OIGB) indicated that "R.A. Willson had expressed the view that by working within a loan limit of $2 to $3M [million] the bank was finding it hard to accomodate business needs and to maintain customer confidence." (13). This was an interesting comment in light of the perceived niche in the Western Canadian middle market that the founders had identified after their "exhaustive research" and in relation to the founding objectives of the Bank. Loans in excess of $3,000,000 were outside the perceived window of opportunity in the supposed needs of Western Canadian businessmen.

In his report to the shareholders in the 1979 annual report, Willson reiterated the Bank's commitment to delegate authority to the branches in accordance with the strategy set out in the original Bank proposal. (14) He advised that, during 1980, the Bank would "... increase the autonomy and the range of services offered by each of our regional offices." as those offices were "... soundly managed by competent and experienced people who are in tune with their communities.". (15)

In the 1980 annual report, Eric Young advised that total assets had increased by 63%, pre-tax profits had increased by 104% and after-tax revenues were up 149% over 1979. Total borrowings by non-residents amounted to only 12% (down from the 50% level reached under the leadership of Hugh Wilson) and the average loan size had increased to $770,000 by year end. Young went on to stress that, although the average loan size had increased significantly, this did not preclude the Bank from making loans of $100,000 and up. (16)

The Bank needed to raise additional capital to continue its rapid growth. In August of 1980, the Bank sucessfully issued a one-for-one rights issue which nearly doubled the capital of the Bank, from $10,900,000 at the end of 1979 to $20,400,000 at the end of 1980. In the 1980 annual report, Willson reported that, "This new capital together with the funds that will become available to us through 1982 warrants will provide a base upon which we can build confidently to our next major target of $1 billion in assets as early as 1984." (17)

At the end of fiscal 1980, total assets stood at $253,900,000, up from $154,800,000 at the end of fiscal 1979. Willson, therefore, was forecasting growth of approximately 300% in four years. Growth, for the sake of growth itself, seemed to have become the prime directive, notwithstanding Young's platitudes about loans of $100,000 and up.

In spite of the problems with Hugh Wilson and the changing directions in lending, the financial results at the end of fiscal 1980 were encouraging. Income (before appropriations for losses) had increased to $1,283,000 in 1980, up from $491,000 in 1979 and $380,000 in 1978 (see Appendix IIb) and earnings per share had risen to $1.31 in 1980, up from $0.57 and $0.44 in 1979 and 1980, respectively.

The loan loss experience of the Bank was $294,000 in 1980, down from $436,000 in 1979 but up from $35,000 in 1978 (see Appendix IIc). Non-performing loans had been insignificant in the early years of operation but reached $5,000,000 in 1980.

Northland's share price closed fiscal 1980 at a price of $18.50 per share, very close to its high for the year of $18.75, and eclipsing the 1979 high of $16.00. Return on average assets was .62% and return on common shareholders equity was 9.4%. Overall, the financial results indicated steady growth and improving profitability.

The Board of Directors

At the beginning of Willson's term as President, the composition of the Board of Directors was essentially the same as when the bank commenced operations. Although some changes had occurred, in most instances these had resulted from the replacement of the designated representative of specific shareholders. (18) The shareholders of the bank had not changed significantly from the time of the founding of the Bank.

The increase in capital in 1980 resulted in new shareholders and Directors of the Bank. The new group of Directors had much more diverse backgrounds than the founding Directors. R.A. Willson stated in the Report to the Shareholders in the 1980 annual report that "The broad business acquaintance of the Directors joining our Board to represent new shareholdings also represents a wealth of opportunities for extension of Northland service." (19) Some members of the previous Board had been asked, and had agreed, to step down in order to allow the new members to fill their positions. (20) These Directors agreed it was in the best interest of the Bank to raise additional capital and to have new members on the Board. Three Directors resigned from the Board in November, 1980: Donald Larson, Bernard Martin and Earl Foster. (21)

In 1980, the size of the Board of Directors was increased by resolution to twenty-two, an increase of eight members from the original Board in 1977. (22) As indicated by the following list of the ten new Board members of 1980, they represented a much broader spectrum of business than had the previous members of the Board:

Thomas R. Goodson	Partner	Littlechild & Goodson Edmonton, Alberta
Richey B. Love,	Partner	Macleod Dixon Calgary, Alberta
Ralph B. MacMillan	President	Edmonton Properties Ltd. Edmonton, Alberta
Roy R. Naudie	Senior Vice-Pres.	The Standard Life Assurance Company Montreal, Quebec
Victor N.Osadchuk	Director	Majestic Wiley Contractors Limited Edmonton, Alberta

Donald B. Rix	President	Metropolitan Clinical Laboratories Ltd. Vancouver, B.C.
Wayne Scott	Vice-Pres.	The Co-operators Calgary, Alberta
Willian W. Siebens	President	Candor Investments Ltd. Calgary, Alberta
Ken M. Stephenson	President	Kenaco Commercial Services Ltd. Calgary, Alberta
V. Kenneth Travis	Chairman	Turbo Resources Limited Calgary, Alberta (23)

Of the twelve continuing Directors, at least five represented interests other than the founding prairie credit unions or co-operatives:

Robert A. Willson		
Lucille M. Johnson	Senior Vice-Pres.	RivTow Straits Ltd. Vancouver, B.C.
John J. Niehenke	Senior Vice-Pres	Girard Bank Philadelphia
Guenther Schmidt-Weyland	Director	DG Bank Frankfurt
Donald G. Skagen	President	Mohawk Oil Co. Ltd. Calgary (24)

Hiring another President

The committee responsible for locating a President had continued its search during the time the bank was raising the new capital but once the offering was closed it increased its efforts. R.A. Willson, who chaired the search committee, had prepared a list of hiring criteria which included weighted criterion. The efforts of the committee resulted in a short list of five candidates. The ultimate choice of the committee was Walter A. Prisco, who joined the bank as President on January 16, 1981 and subsequently became its CEO on July 23, 1981. (25)

CHAPTER FOUR

1981-1983

This chapter examines the development of the Bank under the leadership of its third President, Walter A. Prisco. The leadership of Prisco and the strategies pursued during his term are considered. The operating results are also reviewed.

Walter A. Prisco - President

Prisco was a career banker and had been a senior officer of the Mercantile Bank ("Mercantile"). He enjoyed a good reputation as a lender with a strong credit background (1). According to a former officer, the Board viewed Prisco's experience with a "more sophisticated bank" as a significant asset. (2) It was anticipated that he would evaluate the credit systems and procedures and then implement new controls and procedures as necessary.

After his preliminary assessment in early 1981, Prisco concluded that "leadership was weak and that few systems were in place to control credit authorization". (3) He concluded that "... great risks had been taken on and the quality of loans was substandard and inferior; 8 per cent of the portfolio was in serious difficulty." (4) To remedy the weak credit control systems, Prisco implemented policies and systems similar to those in place at the Mercantile Bank at the time. Some of the policies and guidelines even adopted the exact wording of Mercantile policies. (5)

Prisco was highly critical of the credit record of the Bank and was concerned about the high level of non-productive loans. (6) In conjunction with the revisions to the credit functions in the Bank, Prisco established the office of Chief Inspector to provide better internal control and monitoring of existing loans and embarked on a program of rapid growth which was designed to reduce the problem loans as a percentage of the overall loan portfolio. (7)

Prisco was more concerned about reducing the number of problem loans as a percentage of total loans than he was about fulfilling the original objectives of the Bank. (8) He was concerned about the non-productive loans, lending practices and credit policies (or lack thereof). As reported by Estey, Prisco almost completely stopped new lending during October and November of 1981 while an assessment of problem accounts was conducted. (9)

Although Willson and the first Vice-President Credit, Peter Saunderson, considered the Bank to be a cashflow lender (as discussed in Chapter 2), after evaluating the loan portfolio, Prisco concluded that the Bank was "... essentially an asset-based finance company.". (10) He went on to set up credit guidelines that by Estey's description were "... rudimentary and the fact they were needed in the bank reflects the new President's assessment of the state of affairs in the bank by 1982, and the quality of prior management.". (11)

Prisco was a flamboyant spender. (12) He established new headquarters for the Bank in a new building with Northland's name on it and spent approximately $3,000,000 on leasehold improvements. During a visit to the twenty-sixth floor while the improvements where being installed, Chairman Willson was amazed to see a standup bar thirty feet long, complete with brass foot rail and padded top, being installed in open view on the executive floor. He quickly (and angrily) vetoed the bar and ordered it to be removed. For his own office Prisco ordered elephant hide chairs (rumored to have cost $5,000 each) (13): he felt it was essential that Northland create the impression of being a "big bank" and, therefore, it had to look like one. (14)

Prisco had an extremely autocratic and abrasive style of management. In the words of a former officer of the Bank, Prisco was "astonishingly cavalier" in dealing with other management and the Board itself. (15) Prisco was quoted as often stating that he "enjoyed running his own train". (16) His style of management was a significant contributing factor to an insurmountable conflict which arose between Prisco and the Board in early 1982.

Results

Prisco's term as President ended in late July, 1982 and there can be no doubt that Prisco's leadership had a significant effect on the 1982 results. Nevertheless, the 1982 results are examined below as part of the discussion relating to the successor to Prisco. Although the comments contained in the annual reports are a useful summary of the prior year, the reports also contain the objectives formulated by management at year end. For the purposes of this paper, the operating results and the reports of management were viewed as more relevant in the context of forecasting and setting objectives than in attributing results to earlier Presidents. Also, the incumbent at year end had considerable latitude in terms of taking reserves and deferring or recognizing anticipated losses so the results may more accurately reflect the influence of management in place at year-end than at mid-year.

At the end of fiscal 1981, Northland had achieved most of the objectives set by management at the end of 1980.

Assets had doubled to more than $515,000,000 and income had risen to $4,371,000, up from $1,283,000 in 1980. Return on average assets had almost doubled from .62% in 1980 to 1.14% in 1981. Earnings per share had increased from $1.31 per share in 1980 to $2.14 per share in 1981 and the Bank had paid its first dividend ever of $0.05 per share on July 24, 1981. (17)

Non-performing loans had increased to $10,600,000 at year-end, up from $5,000,000 in 1980. The Bank's provision for loan losses rose eight-fold to $1,258,000 from $153,000 in 1980. Loan losses increased by almost sixfold to $1,720,000, up from $294,000 in 1980. (18)

In their comments to the shareholders in the 1981 annual report, Willson and Prisco made reference to the volatile interest rates, continued high inflation rates, a slowing of the Canadian economy and the Federal Budget (no specific mention was made to the National Energy Program which was announced in October, 1981). Prisco specifically addressed the recession which had begun in June 1981 as a result of the above factors. (19) He also discussed the reduced interest spread which had resulted from the large movements in the interest rates, and the problems of matching funding and lending. With the large increase in assets during the year, the negative effect of the lag when interest rates dropped at the end of the year was greater than the positive effect which had occurred earlier in the year when rates had rapidly increased. (20)

The downturn in the economy and the increased interest rates had also begun to affect the customers of Northland directly and these problems had increased in the latter half of the year. The difficulties being experienced by the borrowers had manifested themselves by negatively impacting the Bank's earnings in the last quarter of 1981. (21) The large increases in the loan loss provision and loan losses (see above) indicated the extent of these problems.

As Northland relied on short-term funds from the wholesale money market, virtually all of its lending was done on a demand basis with floating interest rates. (22) This was done so any increases (or decreases) in the cost of funds would be passed along to the borrower and the Bank would not be caught with mismatched funding. In practice, however, the interest spread was reduced because the funding commitments were on a term basis (albeit short-term) and the lending rates tended to be adjusted very quickly in response to changes in the trend-setting Bank of Canada rate. Northland had to follow the lead of the major banks in quickly adjusting its rates to stay competitive. To try to maximize interest income, the Bank usually delayed a few days before changing its rate and it typically maintained a marginally higher prime rate (and most borrowers seemed to be unaware of this fact).

The other flaw with the theory (at least in the case of Northland) was that it presumed that the borrowers had the ability to service or repay the loans even if interest rates rose significantly. In reality however, many borrowers of the Bank were unable to make sufficient payments to keep interest current once the economy started to slow and rates increased. Also, as the value of assets such as real estate and oil and gas started to decline it was becoming apparent that some of the loans were inadequately secured.

Northland had been very aggressive (or insufficiently conservative) in its lending and its borrowers tended to have higher debt/equity ratios than those of the Big Five. When interest rates rose there was a proportionately greater negative effect upon Northland borrowers than on Big Five customers. Also, Northland generally charged higher interest premiums (partly due to the high cost of funds from the wholesale market) and fees on its loans than the Big Five and this caused Northland to be perceived in the market as a "lender of last resort": a place to seek funds after being rejected by the Big Five. Unfortunately, this resulted in numerous borrowers, who were judged unacceptable credit risks by the Big Five, seeking (and obtaining) loans from Northland. (23)

In spite of the recession which was deepening in Western Canada, the Bank was still maintaining ambitious growth objectives. The goals for 1982 were set out in Willson's report to the shareholders in the 1981 annual report. The stated objectives were not inconsistent with the objectives set out at the time the Bank was formed, but the primary focus was on growth and there was much less emphasis placed on providing services and capital to smaller Western Canadian businessmen and corporations. The objectives which had been endorsed by management and the Board included:

> (1) increasing Northland Bank's share of the still growing western Canada market with emphasis on quality.
>
> (2) strengthening control of cash and operations management with full implementation of our computer programs.
>
> (3) expanding sources of funds.
>
> (4) pursuing larger business loans, made possible by the Bank's increased capital and earnings, in concert with bank partners.
>
> (5) instituting an active internal management development program.
>
> (6) diversifying sources of income, and otherwise compensating for an inevitable period of diminished general business activity. (24)

Although the "inevitable" downturn of the business cycle was identified, the Bank nonetheless forged ahead with its plan of continued growth. (25)

Prisco also endorsed the strategy of growth in his comments in the 1981 annual report. (26) However, he spoke of growing "less rapidly" in apparent recognition of the recession. Prisco also spoke of the priority of developing competence in oil and gas lending and of capturing an "appropriate share" of that market. In relation to funding, Prisco discussed the need to diversify funding to "...minimize our vulnerability to volatile interest rates and concentration of sourcing.". (27)

Notwithstanding that Prisco was highly critical of the loan portfolio, credit policies and previous lending practices, he also endorsed the concept of delegating responsibility and authority to the branches. In the President's Report in the 1981 annual report, Prisco stated that, "We are continually driving down the decision-making to the point of sale so that ultimately the head office function will be one of policy setting." (28) It is remarkable that, in spite of his opinion that leadership was weak, the control systems were poor and that great risks had been taken (29), he was prepared to delegate an even greater amount of decision-making authority to essentially the same individuals who were responsible for

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the problems that existed when he joined the Bank.

The "Departure" of Walter Prisco

In his report, Estey concluded that there were two principal reasons for the departure of Walter Prisco. Firstly, the Board had refused to accept his proposal to strengthen the capital base of the Bank by the acquisition of a guarantee corporation, and, secondly, Prisco had threatened to hold a press conference to disclose that a loan secured by property in the Cayman Islands represented a potential write-down of $6,000,000. Estey concludes that the second consideration may have been viewed by Prisco as retaliation against the Board for refusing his proposal. (30) One of the Board members interviewed felt that the threat by Prisco was an attempt to force the Board into agreeing to the acquisition of the guarantee corporation. Johnson writes that the initiative to increase the capital base was made because of the perceived need to offset potential loan losses. (31)

According to one of the former officers of the Bank, Prisco did not provide any Board member with information about the proposal to acquire the guarantee corporation prior to the meeting at which he requested the Board's endorsement. (32) Prisco presented each Director with a package of materials at the meeting and then requested approval of the purchase on the strength of his recommendation alone. Prisco indicated that time was of the essence and that the deal had to be accepted immediately or the opportunity would be lost. When some resistance was encountered, Prisco suggested that, if the Board was not prepared to trust his judgement, perhaps he should rethink his commitment to the Bank. Some of the members of the Board agreed that this would be appropriate and the proposal was tabled for further consideration.

After the meeting, Prisco and one of the members of the Board (who stood to make a fee in the order of $300,000, which fact had been included in the materials given to the board but had not been disclosed at the meeting) requested Willson's attendance in Prisco's office for a meeting relating to the proposal. Prisco and the Director indicated to Willson that they had been doing a lot of thinking about the proposal and they had concluded that Willson was acting in his own self interest and not in the best interests of the Bank. Further, they felt it was essential that the capital of the Bank be strengthened and that the acquisition of the guarantee corporation was a golden opportunity to do so. According to Willson, they told him that they would "punish" him if he did not support the proposal. (33)

At this point in the meeting, Willson told them that this was all very interesting and that he would like to reflect on what they had told him. He retreated to his office and immediately wrote down his recollection of the meeting. Willson then called an emergency meeting of the Board. At the meeting Willson read his memorandum to the Board in front of Prisco. When asked by Alan Scarth whether the acccount of the meeting was accurate Prisco shrugged his acknowledgement that it was. It was immediately moved that Prisco be suspended pending further investigation and that Willson should be appointed provisional CEO. (34)

Prisco was subsequently evaluated and the Executive Committee of the board passed a resolution recommending that Prisco be terminated for cause and that Willson be appointed CEO. (35) Rather than acting on the recommendation of the Executive Committee to terminate Prisco, the board elected to accept his resignation in June of 1982. (36) Notwithstanding that Prisco formally resigned, the Estey Report used the term "dismissed" in relation to Prisco's departure from the Bank. (37)

There is some disagreement between those officers interviewed as to the condition of the Bank at the time of Prisco's departure and whether the ultimate result might have been different had Prisco stayed. One of the former officers of the Bank suggested that if Prisco had remained as President the Bank would never have reached the state it did before attention was focused on it by the Office of the Inspector General and other groups within the government. (38) The officer felt that Prisco would not have disguised or concealed any problems. (39) The fact that Prisco had virtually halted lending during the months of October and November 1981 to assess the problem loans and to take appropriate reserves supports the opinion that Prisco was prepared to formally acknowledge problem accounts and potential losses. (40)

Other officers interviewed disagreed with the conclusion that Prisco would have disclosed any serious problems with the loan portfolio, citing the fact that many of the loans that troubled the curator were put on during the Prisco era. Also, during the third quarter of fiscal 1982 Willson reversed approximately $1,000,000 of accrued and previously recognized interest which represented the first loss of the Bank. (41) This interest had been accrued and taken into income during Prisco's tenure and he had chosen not to reverse it.

R.A. Willson - President Again

Once Willson reassumed the role of President in mid-1982 he soon became aware there were more non-productive loans than he had previously thought. He stated that Prisco had not made him aware of the extent of non-productive loans and that he had been too remote from lending to realize the severity of the problems. (42) According to Willson, once he had apprised himself of the situation, he convened a meeting of the lending officers and outlined his strategy to deal with the problems. (43) The plans were to diversify the loan portfolio, establish standby lines of credit as a contingency plan if funding became difficult, increase the number of money market sources and focus greater attention on the non-productive loans. (44) The lending guidelines and credit approval system which had been established by Prisco remained essentially unchanged.

The decision was made to leave the responsibility for the non-productive loans with the branch managers. The Bank was still pursuing the objective of operational autonomy for branch managers. In the 1982 annual report, Willson wrote that the Bank had achieved the goal of "... increased speed in decision-making through the strenghtening of regional office autonomy, thereby facilitating quick response at the point of sale.". (45) He also commented that, due to the difficulties caused by the recession, loan officers had become financial counsellors and had been required to work at restructuring loans, realigning assets, [and] reassessing security....". (46) Willson recognized that there were high operating and opportunity costs associated with troubled loans but the deliberate decision was made to leave the problem loans with the account officers and branch managers. (47)

After Prisco's departure from the Bank, Willson, as acting President and CEO, still sought to increase the size of the of the Bank but at a more moderate rate than in the past. In the 1982 annual report, Willson projected growth of assets of 27%, a much slower rate of growth than he had strived for during his initial term as President. The rate of growth did slow during Willson's second term at the helm from mid-1982 to mid-1983. The problems with the loan portfolio were increasing and greater attention was focused on solving problems with the existing loan portfolio than on continued rapid growth.

Results

At the end of fiscal 1982, 91.4% of the bank's loans were in the western provinces, with 56.9% in Alberta alone. The remaining 8.6% of the portfolio represented international loans. Under Hugh Wilson, the percentage of domestic and international loans had been almost evenly divided. The Bank had succeeded in its goal to align its lending practices more closely with its original objective of serving the Western Canadian market. While achieving its goal, however, the Bank had made itself even more vulnerable to the cyclical nature of the Western, resource-based, economy.

The domestic loan portfolio was also highly concentrated by industry in real estate and energy. Loans and asset values in these industries had begun to drop after the National Energy Program was invoked by the federal government in October of 1981. Although in 1982 the full impact of the recession had not yet been felt by the Bank, the drop in secured asset value and increase in non-productive loans was of great concern. The interest reversal in the third quarter of 1982 was the first reported loss of the bank. (48)

By the end of fiscal 1982 Bank assets totalled $653 million, up 27% from 1981. Although the objective for continued growth had been achieved, the profitability of the Bank had dropped significantly. On a fully diluted basis, earnings per share had dropped from $2.13 in 1981 to $0.79 in 1982. The return on average assets had fallen from 1.14% in 1981 to .31% in 1982 and the return on average equity had dropped from 16.6% in 1981 to 4.7% in 1982. The share price had reached a high of $17.00 per share but closed out the year at a price of $6.63 per share, only slightly higher than its low for the year of $6.38 per share. (49)

The loan loss experience of Northland increased from $1,720,000 in 1981 to $2,776,000 in 1982 and the non-productive loans increased dramatically: from $10.6 million at the end of fiscal 1981 to $99 million at the end of fiscal 1982. These large increases in losses and non-productive loans caused the Bank to begin to shift its focus from fulfilling its original mandate to solving the problems existing in the loan portfolio.

In the 1982 annual report, Willson listed a set of priorities which, for the first time, did not largely repeat founding objectives. Because of the poor operating results in 1982, the Bank was forced to focus on profitability rather than growth. The rapid increase in problem loans caused Willson to emphasize "...the conversion of non-productive or slow paying loans to positive income; adding new quality business; strengthened capital adequacy; and reduced non-interest costs.". (50) Another priority was to establish "Performance targets - and accountability - for every segment of the Bank's operation." which was a distinct change from the previous objective of delegating as much authority and responsibilty as possible to the branch offices. (51) This was one of the earliest indications of the realization by Willson that the existing systems of control, accountabilty and management were inadequate.

The other priorities set out by Willson in the 1982 annual report were to expand deposit sources, increase syndication efforts, increase oil and gas lending (to capitalize on "newly created competence") and to improve communication with shareholders and the investment community. (52) The desire to increase deposit sources may have resulted from an increasing awareness of the vulnerability of the bank to the volatility of the wholesale money markets. Syndications may have been emphasized to take pressure off the Bank's capital and funding requirements by selling off assets (presumably at a profit through fees or interest "clips").

The objective of increasing communication with shareholders and the investment community suggests that Willson felt that the Bank's stock had not been adequately supported by the market. Although little emphasis was placed on growth, the desire to expand energy lending and to expand "new quality loans" demonstrate that the objective of growth had not been completely abandoned.

CHAPTER FIVE

The Fourth President

This chapter discusses the search for, and the background of, the fourth President, William E. Neapole. It also examines the status of the loan portfolio of the Bank when Neapole arrived in 1983.

The Search for the Next President

Willson was also given the mandate to find a President and CEO. He was given this task as a committee of one. Given the past history of the Bank (and Willson) in selecting Presidents this is somewhat surprising. The board apparently felt that the role of the President was now quite clearly defined. (1) Willson viewed the challenge as finding the right person, not in trying to further refine the criteria for selecting a President or in redefining the responsibilities or mandate of the position. (2)

These conclusions by Willson and the Board are noteworthy in that even though the economic environment was undergoing significant changes and was in a very volatile state and the profitability of the Bank had suffered during fiscal 1982, the selection criteria were still judged to be optimal. In his address to the shareholders in the 1982 Annual Report, he had acknowledged that the challenges facing the Bank had changed and he had set forth a set of goals and objectives that were significantly different from the founding objectives of the Bank yet he did not feel that the overall mandate for a President/CEO had changed. As there was no one at the Bank with the experience necessary to fill the position of President, Willson again took the search outside the Bank.

At the conclusion of the search, which was conducted with the assistance of professional executive recruiters, William Neapole was invited to join the Bank as Senior Vice-President on the understanding that he would be appointed President at such time as the Board of Directors determined that he was worthy and capable of assuming the position of President. As a result of the experiences with the first two Presidents, the Board was reluctant to appoint a President who had not proved himself within the system (3), although they were prepared to have Willson make the decision as to who should be hired.

Background

William Neapole was a career banker with twenty-five years of service with The Royal Bank of Canada. He had been well recommended by banking contacts of Willson.

Neapole had been the manager of the main branch of the Royal Bank during the boom in the late 1970's in Calgary and had reputedly increased the loan portfolio at that branch by $1,000,000,000 during his tenure. Although given the title of Senior Vice President upon joining Northland, it was understood by management and staff that Neapole was the heir apparent for the position of President and CEO, which appointment was made in mid-1984 (4) (for the purposes of this paper, it is assumed that Neapole, had effective authority as President and CEO from the time of his employment with the Bank, although the formal appointments were not made until early 1984).

By the time Neapole joined the bank in May of 1983, the bank was in serious difficulty. The deep recession in Western Canada had weakened the loan portfolio and the loss in value combined with the inability of many borrowers to repay their loans posed a serious threat to the Bank. The policy of delegating responsibility and authority for both lending and problem solving had resulted in almost complete delegation (or, perhaps, abdication) of responsibility by head office for branch operations. There was little, if any, guidance provided to the branches by senior management as to how to account for, and deal with, non-productive loans. Most branch managers and senior managers continued to believe that the problems were very limited and temporary and [illegible] belief was reflected in their analyses, reports and forecasts. (5) The widespread attitude amongst Bank management (and most Westerners) was that the economy would recover and the value of the secured assets and the ability of the borrowers to repay would be restored. (6) Senior management continued to seek good news and positive results; bad news was not welcome at head office.

As a result of the prevailing attitudes and policies, the branch managers tended not to disclose the true extent of the problem accounts in their portfolios; they stressed the positive aspects of each account and adopted the most optimistic method of valuing the assets securing the loans. (7) This approach was almost universal within the Bank and was implicitly endorsed by the senior management in head office. Although the convention in Canadian banking was to put loans on non-accrual where interest was 90 days in arrears, Northland continued to recognize income on many accounts where interest remained unpaid past 90 days. (8)

Previously, senior management had rarely visited the branches and this may have also contributed to the lack of overall awareness and understanding of the realities of the problems in the loan portfolio. Account managers rarely had any direct contact with senior management. Additionally, head office files contained a very limited amount of information as the decision-making responsibility for most decisions was maintained at the branch level and head office rarely was involved in any decisions after the initial credit decisions. No one fully understood the magnitude of the difficulties with the loan portfolio at the time Neapole joined Northland. The objective of almost complete delegation to the branch level had been achieved. Unfortunately, the results were not as expected.

The Portfolio

As Martin Fortier testified before the Estey Inquiry, when he became aware of the extent of the problems after being promoted to Senior Vice-President in late 1983, he was "shocked" by the condition of the portfolio. Fortier had previously managed the Prince George, British Columbia branch and subsequently had been transferred to Edmonton as the General Manager of the Northern Alberta region. He then discovered a portfolio which, in his own words, "would have been more appropriate for a real estate development company than a chartered bank.". (9) There was a heavy concentration of real estate loans and no organized strategy for dealing with the non-productive loans.

The problems Fortier had uncovered in the Edmonton portfolio caused him to be gravely concerned about the quality of the Bank's entire portfolio, but it was not until he was promoted and transferred to Calgary head office and began his own investigation that he realized how serious and widespread the problems actually were. (10) He quickly realized that extaordinary measures would be required if the Bank was to survive. Fortier was appointed Chief Operating Officer in 1984 and was directly responsible for the day-to-day operations of the Bank including new lending and workouts. He was very "hands on" and his presence was felt at all levels of the organization.

Immediately after Neapole joined the Bank, he hired Iain McLeod as Chief Inspector. McLeod's mandate was to conduct a thorough and comprehensive analysis of the loan portfolio. McLeod, a career banker with over thirty years of experience with the Royal Bank of Canada, presented his resignation with his report, having concluded that the Bank's porfolio was a disaster when evaluated using traditional banking criteria. (11) Neapole contacted McLeod at his home by telephone and persuaded him to reconsider his decision and to stay with the Bank, arguing that the poor condition of the Bank's portfolio made it essential to have the assistance of experienced bankers to solve the substantial problems facing the Bank. (12) Neapole's plea was successful and McLeod stayed with the bank until after the appointment of the curator in 1985.

Although McLeod had reported that the condition of the portfolio was a disaster, Neapole must have felt that the situation was salvageable. Rather than disclosing to the world that the Bank was in serious difficulty, he chose to try to lead the Bank back to profitability. Unfortunately, the system did not offer many viable alternatives. There was no means to formally recognize the problems and still try to carry on business (with the possible exception of curatorship under the provisions of the Bank Act, the results of which shall be discussed in later chapters). As Neapole had started with the Bank only months prior to receiving McLeod's report, it is difficult to know whether he genuinely believed that the problems were as severe and widespread as McLeod had concluded and there was no other choice but to continue operating or declare insolvency or whether he discounted McLeod's report and believed that McLeod had overreacted and that the problems were more manageable than reported. Irrespective of the reason, Neapole and the other senior managers chose to push forward aggressively with an attempt to restore the Bank to profitability.

The following chapters examine the situation that existed when Neapole joined the bank, the background on the relevant issues and indicators, and the strategies which were implemented in an attempt to solve the problems. The one conclusion that was shared by all of the former senior managers of Northland interviewed was that in 1983 the Bank could not have been saved by conventional methods. The seriousness of the problems dictated extaordinary solutions if the bank was to survive.

Interestingly, no one suggested that a better alternative had existed. The perceived choices were to either declare insolvency and be liquidated or to pursue an aggressive, creative (and, in retrospect, very risky), attempt to salvage the Bank. Liquidation was not viewed as an acceptable alternative to the management of Northland. It is the writer's opinion that management did not consider a sale or merger of the Bank to be a viable alternative as there was insufficient value in either the loan portfolio or the organization to attract a purchaser or a merger partner.

Neapole's involvement with Northland is inextricably linked to the development and implementation of the numerous and varied workout strategies utilized by the Bank. His involvement with the bank will be considered in much greater detail in conjunction with the examination of the strategies which were employed by Northland as it struggled to survive between May of 1983 when Neapole joined the Bank and January 20, 1986 when Touche Ross Limited was appointed Liquidator of Northland Bank.

CHAPTER SIX

The Turnaround Attempt

By 1983, the problems facing the Bank were widespread and severe. It was apparent to Neapole and Fortier that the strategy of delegation to the branches had failed. In addition to poor lending and account management, the system had failed to communicate the true status of the Bank's loans to senior management in head office. To begin the attempt to cure the existing problems with the accounts and to restore profitability a number of strategies were implemented. This chapter examines the development of these strategies which were adopted in 1983 by Neapole and Fortier.

Strategies for Survival

By the end of 1983, the Bank had developed a set of strategic objectives designed to restore profitability. Some of the objectives developed were inconsistent with those set forth in the proposal for the creation of the Bank but in 1983 the survival of the Bank vastly outweighed any idealistic notions of maintaining a regional bank in Western Canada which was totally reliant on the volatile wholesale money market for its funding. The strategic objectives were to:

1) increase the size of the bank through quality lending in order to reduce the non-productive assets as a proportion of total assets

2) diversify geographically in order to capitalize on the healthier economy of Eastern Canada and to reduce the market perception of Northland's vulnerability in the devasted markets of the West

3) diversify by industry in order to reduce the proportion of real estate and oil and gas loans

4) increase the capital base of the bank in order to permit rapid growth and to offset capital erosion from loan losses

5) stabilize funding by establishing a retail deposit network

6) increase income by charging higher fees, increasing the interest spread while maintaining low administrative costs, reversing interest wherever possible, and by taking fees into income rather than amortizing over the term of the loan

7) acquire time where possible to defer the impact on the financial statements and to allow the Western economy to recover.

8) improve monitoring and collection procedures for existing loans and attempt to minimize the exposure and maximize the recovery on troubled loans and foreclosed properties through innovative workouts and restructurings.

9) manage the income statement and balance sheet to maintain the confidence of shareholders, depositors, regulators and the wholesale money market. (1)

These objectives echoed the theme of Willson's comments in the 1982 Annual Report in that they were designed to restore profitability but they were much more ambitious, diverse and specific than Willson's general solutions.

There were a number of elements essential to the successful implementation of these strategies: competent staff and management, good credit policies, adherence to the credit guidelines, aggressive marketing, prompt client service, willing borrowers able to provide adequate security, sufficient capital, adequate funding at an acceptable price, good follow-up and monitoring, rapid problem recognition and competent loan work-outs. Perhaps the most important requirement of the Bank was time: time to implement the strategies and for the improvements to (hopefully) take place.

The Bank was saddled with extensive troubled loans, a deteriorating economy and a relatively inexperienced management team, yet the fundamental plan was to grow out of the problems through aggressive lending and problem-solving. The majority of lenders had curtailed lending activities in Western Canada due to the declining value of real estate and energy security but Northland planned to go against the majority and hoped to capitalize on perceived "contrarian" opportunity. Unfortunately for the Bank and its management, other than declaring insolvency, there was no other choice apparent in 1983.

The situation required extreme and diverse actions to keep Northland afloat. As Estey concluded "There can be no question on the evidence that Northland in 1983 was facing very substantial financial problems.". (2) The sections below assess these strategies in more detail and set out the reasons why Northland management believed they were achievable even in the face of a depressed market and a deteriorating loan portfolio.

Growth

As set out in Appendix IId the amount of loans of the Bank increased from $531 million at the end of fiscal 1983 to $1.118 billion on August 31, 1985. According to R.A. Willson, the strategy of growth pursued under Neapole was not a continuation of the strategy initiated by Prisco. Growth had not been vigorously pursued during the term between Prisco's departure and Neapole's arrival. (3) The rekindled emphasisis on growth was an integral part of the overall strategy developed by senior management during Neapole's tenure as President. The rationale was the same as for rapid expansion during the tenure of Prisco; by increasing the size of the Bank by adding a large volume of good loans (it was always assumed that all new lending would remain productive) the ratio of problem loans would be reduced.

The Big Five had taken the view during the recession that there was very little profitable lending to be done in

Western Canada. Large corporations in the West continued to borrow through the head offices in the East while local lending in Alberta virtually stopped. In addition to the cessation of new lending, the Big Five were active in trying to collect outstanding loans and would often not grant renewals of existing credits on the basis that the value of the security or the covenants of the borrowers were no longer sufficient to justify a continuation of credit.

The management of Northland felt that the large banks were dealing with borrowers in Western Canada on a mass basis rather than case by case and that many of these borrowers were acceptable credit risks. There was continued optimism at Northland that the Western recession would be relatively short-lived and that there was an underlying value in the real estate and energy security which would once again be recognized by the market when the recovery occurred. Also, assets that were liquidated by lenders were being sold for substantial discounts when compared with the 1980 "values". Accordingly, liquidation of the non-productive accounts was not a viable alternative for Northland. There were very few buyers and the prices that prevailed would have required the Bank to recognize losses it could not have sustained.

Northland management felt that the actions of the Big

Five had created a window of opportunity in lending in Western Canada. It is a common criticism of the Canadian banking industry that a "herd mentality" prevails. The banks are perceived to prefer to lend in markets where and when all the other banks are active. The senior management of the Bank felt that the Big Five had over-reacted to the problems in the West and that this response had opened up the opportunity for Northland to fill the credit gap created by the reductions in lending activity of the majority of financial institutions operating in Western Canada.

Diversification

The effect of the recession was especially profound on regional lenders such as Northland. Having concentrated its lending activities in the oil and gas and real estate markets in the West, the Bank was now paying the price for the previously lucrative lending. Management determined that it was essential to commence the diversification of the loan portfolio, both geographically and by industry. As a recovery had commenced in Eastern Canada, the Bank elected to expand into the Ontario marketplace.

Even though that market was the backyard of the Big Five, the Northland was confident that an alternative to the Big Five would be welcomed and that there were sufficient niches in the market to provide good business and large volumes. No market research preceeded the expansion to the East. It was simply assumed that good lending opportunities existed in the East for a bank that was more aggressive and entrepreneurial than the Big Five. Management also believed that by increasing its activities in the East, the Bank would increase its profile and stature and change its image, both in the banking industry and to the public, from that of a second-class regional lender to that of a well-established national institution. Maintaining a positive image was essential to retaining the confidence of shareholders, analysts and the money markets.

The move to diversify by industry was intended to spread the lending risk over a number of industries, some of whose activities and trends would be counter-cyclical to other industries which would tend to reduce the Bank's vulnerability of the Bank to the volatile Western economy and to boom and bust cycles. The Bank specifically sought to minimize its reliance on, and exposure to, Western real estate and oil and gas and to reduce the high percentage of these loans in the portfolio. Unfortunately, this objective proved difficult to achieve. In Western Canada, the majority of the lending activity of the Bank continued to be asset-based and primarily in the real estate and oil and gas sectors. The initiative to diversify by industry met with somewhat greater success in Ontario with its larger population, broader industrial base and higher concentration of business activity than existed in Western Canada.

Additional Capital

To support the planned growth of the loan portfolio, it was necessary for the Bank to raise capital. Part of the emphasis on continued reported profitabilty arose from the necessity to raise additional capital. The confidence level of the financial analysts and potential investors had to be maintained. A combination of shares and debenture issues were contemplated to minimize the dilutive effects of additional share issues alone. A strong capital base was essential to provide the leverage necessary to expand the loan portfolio, to offset the erosion caused by the loan write-offs and to present a strong financial picture to depositors and investors.

Funding

The original concept had been that the Bank would utilize wholesale money markets for all its funding requirements. For a fledgling financial institution, this means of gathering funds allowed the Bank to maintain a very small staff able to concentrate on lending rather that funding. The higher costs of the wholesale funds were offset by the savings in administation costs. Although this funding method served the Bank adequately during its early years, the volatility of the wholesale market became a cause for concern in late 1982 when funds were withdrawn from the Bank as a result of the Crown/Greymac/Seaway affair ("trust companies affair") when a close business associate of Howard Eaton, Leonard Rosenberg, tried to take over control of the CCB in contravention of the Bank Act limitation of 10% for any single investor. (4) Standby lines of credit in the amount of $250 million had been arranged with the Big Five to ensure liquidity. (5)

As a result of these difficulties, the Bank concluded that it was necessary to reduce the reliance upon the wholesale money markets and it embarked on a program to raise retail deposits in late 1982. The retail funding was expected to provide a much more stable funding base due to the large numbers of small investors and the fact that the vast majority of the retail deposits would be protected by the Canadian Deposit Insurance coverage on deposits up to $60,000. Although the costs to establish and maintain the network were expected to be substantial, these were expected to be partially offset by the lower cost of funds in comparison to wholesale deposits. It was concluded that a retail network was essential so a Vice-President was given the mandate to establish a small branch system.

The plan that eventually evolved was to create a network of "boutique" branches that would appeal to wealthy clients who would provide the Bank with proportionally larger deposits than the average bank customer. The boutique concept had arisen from a perceived demand for superior banking services for wealthy bank customers. The objective was to attract large amounts of deposits at a relatively low cost by providing superior banking services to an exclusive clientele.

At the time Northland decided to establish its system, the profitability of the concept had not been proven. A few banks in the United States had established boutique branches, but on a trial basis only. Nevertheless, the Bank perceived the lack of competition in boutique banking as an opportunity and decided to set up the network. Also, the Bank did not have sufficient capital available to establish a large deposit gathering network (it could be argued that the Bank did not have sufficient capital to open even one branch).

When interviewed, one former officer stated that in his opinion, the Bank had not adequately analyzed the financial impact of creating a retail network, on either a conventional or boutique basis. (6) According to the same officer, at a management seminar held in Banff to discuss the boutique system, it was evident that the executive in charge had not conducted an indepth cost/benefit analysis; he had accepted his mandate to set up the system without questioning the assumptions upon which the decision had been made. The approximate cost of opening a branch was known but the income and the positive impact on retail deposit gathering was assumed. (7)

The concern over the volatility of the wholesale deposits was apparently sufficient justification for Northland management. The feeling in the Bank was that as long as the Bank was reliant on wholesale funding, there would be the potential threat of a liquidity crisis if there was any concern over Northland or the financial markets generally which precipitated a "flight to quality" by wholesale depositors. Because of this fear and having concluded that an opportunity existed to be a market leader in boutique banking, Northland had concluded that a retail network was essential.

The Bank also considered other rather innovative retail fund gathering techniques. At one point, there was serious consideration given to joining forces with one of the Prairie hardware chains and gathering deposits through the retail stores. By using the existing network and paying a commission on deposits, it was felt that there was the potential to raise a large number of "Mom and Pop" type deposits at a very low cost. At the time this was proposed, the writer was very concerned that if the plan was implemented that, even if successful in gathering deposits, it would have a devastating effect on the market perception of the Bank. Becoming a "hardware store bank" could only have severely damaged the credibility of a bank struggling to create a "big bank" image. The strategy was attempted in a single store in North Battleford, Saskatchewan, but was quickly abandoned in favour of the boutique concept.

Increased Income

The main strategies for improving income were: charge higher fees (and attempt to convince the auditors that they should be realized immediately rather than amortized over the term of the loan), improve the average interest spread on loans, take accrued but unrealized interest into income, and reduce loan loss reserves. In pursuing these objectives, the Bank was moving away from conventional banking (in the Canadian context) and more towards what are typically defined as merchant banking activities. Implicit in the concept of merchant banking are higher returns and correspondingly higher risks than normal banking activities.

Management felt that it was feasible to increase fees while still writing quality loans. The Big Five had virtually stopped accepting new loan applications from Western borrowers who were finding it extremely difficult to obtain new credit. Even borrowers with excellent credit histories were finding that their loans were not being renewed when they matured. It could be argued that the drop in banking activity was a result of the fact that many bank customers had become uncreditworthy due to the drops in the value of real estate and oil and gas; nevertheless, the Northland perception was that a real opportunity existed. It was believed that quality business was being abandoned and that this could be picked up by the Bank at premium rates.

The same rationale was applied to increasing the interest spread on loans to increase the overall yield of the portfolio. In 1984, this strategy resulted in the Bank pressuring its good long-term clients to either pay higher rates or seek refinancing and pay the Bank out. The Bank wanted to re-loan the money to borrowers that would pay higher fees and interest rates. Although the low yield loans were profitable, the Bank wanted to have them repaid so that the capital requirements of new, more profitable, lending could be met. With the rapid growth, there was a concern that unless some of the existing loans were repaid that the capital requirements might exceed the Bank's ability to raise funds. As the Bank was seeking higher fees and interest rates on the new loans (although with higher risks), it was felt the overall interest spread could be improved through the repayment of the low yield loans.

There does not appear to have been much foresight in this approach. Although the yields were lower, the risk was correspondingly low (especially on those loans which other lenders would refinance given the tight credit markets) and by driving the quality business away, the Bank was increasing the overall risk in the loans, driving out good clients (in a manner similar to the Big Five) and reinforcing its reputation as a lender of last resort.

To minimize its exposure to the volatility of the wholesale money markets, the majority of the loans continued to be at floating rates and were due on demand. By structuring the loans in this fashion, the Bank theoretically passed the risks of higher interest rates and funding shortfalls onto the borrower. In practice, however, the problems remained that a borrower had to have the ability to pay higher rates, had to be permitted a reasonable time to repay the loan, and had to have the ability to repay or refinance the loan or the Bank had to have sufficient security to recover the loan amount (which process can take years if a borrower vigorously defends its position).

Increased income was also achieved by taking accrued but unrealized interest into income. This was accomplished by re-evaluating the condition of the borrower or the value of the security and concluding that the interest would ultimately be collectable. In certain cases additional interest was lent to the borrower in which to service existing debt. The creation of Epicon Properties Inc. is the best example of the latter method of re-evaluating the value of security and assets to increase interest income. Through the formation of Epicon, the Bank was also able to recover loan loss reserves, again by a re-evaluation of the assets.

Obtain Time

One of the widespread beliefs that prevailed in both Western Canada generally and within the Bank was that the recession in the West was a temporary phenomenon and that the value of the real estate and oil and gas security and assets was expected to recover. This was translated into strategy by providing every opportunity for borrowers to have more time where it was viewed that the difficulties with the loan, or concerns about value, related to the drop in the market rather than weaknesses in management. If the borrower was perceived to be honest, competent, hard working and co-operative, facilities such as capitalized interest accounts were often set up, usually without the benefit of additional security.

The effect of this approach was to increase the loan amount without increasing security. The level of risk was increasing as the loan increased and the Bank typically took the accrued interest into income although it was being capitalized instead of paid. This went against standard banking practice which is to classify a loan as non-accrual when interest arrears exceed ninety days. (8) This approach also represented a change in policy at Northland. (9)

Management also felt that, given additional time, the organization could become "lean and mean" and that during the "temporary" Western economic recession there was a real opportunity to seize market share while the Big Five was retrenching to the East. Additionally, the Bank was exploring other means to improve profitability such as increasing merchant banking activities. The logical progression for the bank was viewed to be to stay relatively small and fill the niche of high risk/high return lending which was not then occupied by any major lenders. Management was confident of its ability to evolve in that direction given sufficient time to deal with the problem loans.

Time was needed to be able to perfect and implement the multitude of strategies which had been developed and a number of the strategies keyed only on providing that time. Unfortunately, some of those strategies may not have resulted in the best business decisions being made on a present value basis. In some instances additional risks were taken only to obtain more time. The alternative, however, was to risk the immediate failure of the Bank which was certainly viewed as a less desirable outcome for all concerned, including shareholders, creditors, borrowers and management.

Problem Recognition and Workouts

In reviewing the problems in the loan portfolio, it had become clear to management that a significant portion of the problem loans had resulted from a lack of problem recognition and reporting during the early stages of default or non-performance. (10) Greater emphasis was to be placed on early warnings on potential problem accounts so that solutions or recovery strategies could be implemented before the problems became extreme. (11) This was also expected to improve recoveries where realization was necessary as the assets would not be stripped or allowed to deteriorate to any great extent before the Bank became actively involved. One of the trite expressions in banking is that "your first loss is your smallest" in recognition of the necessity for early resolution and problem-solving.

It is noteworthy that early recognition and realization is the opposite approach to capitalizing interest which was also a strategy of the Bank (as discussed above). It might be argued that where the problem has been identified, the risk is much less as the loan will be monitored much more closely and, presumably, action taken if the borrower fails to fulfill his mandate under the workout scenario. However, this argument fails where interest continues to be accrued. Northland continued to take the capitalized interest into income and, as a result, the possibility of full recovery was continually decreasing. In most cases at Northland where interest was not being paid, there was also concern over the value of the security.

According to industry practice, any loans over ninety days in arrears should have been placed on non-accrual and any interest received should have been applied to the outstanding principal balance. By conventional standards, only where the Bank was confident that the loan was adequately secured and that interest would be kept current should interest have been considered income. Northland ignored convention to sustain apparent profitability and to obtain additional time. It had to compromise on the objective of early problem recognition and solution to fulfill the objective of gaining time. Unfortunately, this may have resulted in decisions that were suboptimal on an individual loan basis: the Bank was paying for the additional time by incurring additional risk.

Bulk Asset Sales

Another strategy that was developed by the Bank to aid in dealing with the non-performing loans was to package a large number of them and sell them in bulk. To minimize the negative effect of selling loans and assets that had impaired values, various means were explored to spread the potential losses over the longest possible period and to fix the cost of the losses. Mechanisms such as stripped bonds, providing puts to the purchaser and lending additional funds for interest service and working capital were used.

Although these transactions offered solutions to a significant proportion of the problem loans, the assets were still a drag on earnings. Typically, the rates on the vendor take-back financing had to be quite favorable to entice buyers (especially at book value pricing). One of these transactions, the Rondix deal, is examined in more detail in Chapter X.

Balance Sheet Management

The management of the balance sheet was critical to the survival of the Bank. In order to continue operating, Northland required the confidence of the system (both the marketplace and the regulators) to obtain funding. As is also trite knowledge in the industry, banking is a business of confidence. The leverage provided by the ability to lend twenty times capital is of no use if a bank is unable to raise the deposits or wholesale funds to provide the loans. It was a matter of the highest priority to generate sufficient income in each fiscal quarter, through the implementation of the numerous strategies, to continue to show a profit and maintain confidence.

Maintaining confidence was also vital in regard to raising capital. The strategy of growth required additional capital to be raised and to accomplish this, the Bank had to be able to show that it was operating profitably. Obviously, potential investors had to be convinced not only of Northland's viability, but also of its potential profitability. The ultimate objective of management of the Bank was to restore actual profitability and to have any hope of ever accomplishing that goal, the facade of profitability had to be maintained while the problems were attacked. The only other alternative at that time was liquidation. The officers of the Bank had sufficient experience in liquidating the assets and corporations of defaulting borrowers to know the extremely high costs of liquidation.

CHAPTER SEVEN

The Implementation of the Strategies

The implementation of the strategies that were developed by management required enormous changes within the Bank. In addition to radically changing the way it handled existing business, the Bank was also to expand both the size and scope of its operations. This chapter examines the means by which management began to implement the strategies which had been determined to be essential to the survival of Northland Bank.

Background

The development and implementation of the strategies was begun by a young and aggressive faction which co-opted Neapole very soon after his arrival at the Bank. Since its beginnings, management had been a problem for the Bank. Neapole was the fourth President and CEO in nine years and Willson, who had occupied those offices twice during the Bank's history, had had no formal banking experience prior to his involvement with Northland. As stated by Michael MacKenzie, an auditor of the Bank, at the Estey Inquiry, "Neapole made no secret to us that the bank had a history of bad management". (1) Unfortunately, it was the view of some of Northland's senior officers that the bank had not solved its management problems by the time Neapole joined the Bank.

A number of the senior managers continued to ignore the problems that faced that Bank even as late as 1983. Because of the concern over the operating results of the Bank on a quarter by quarter basis, a practice had evolved at the branch level of reporting loan status in positive and, typically, optimistic terms. There was widespread concern about public perception and confidence in the Bank and as the recession was viewed as a temporary phenomenon, the practice of casting a favorable light on the loan accounts had not been frowned upon. Essentially, until Fortier and Neapole arrived in head office, no one wanted to hear the bad news. By way of example, the Vancouver and Calgary branches had continued to report very few problems in their loan portfolios in early 1983. (2)

Upon closer scrutiny by some senior management and Epicon personnel, it became apparent that serious problems existed in each branch, but the General Managers had either been unaware of the magnitude of the problems or had simply not reported the actual status of the loans. (3) In the Vancouver branch, the General Manager had been monitoring all of the reports of the loan officers and account managers and had insisted on a rewrite of any report that reported or suggested a problem. Due to the delegation of power to the General Managers and the fact that there was virtually no communication with head office by anyone other than the General Manager, branch personnel were afraid to report the problems directly to Head Office. Once the situation was discovered, immediate personnel changes were made to strengthen branch management and to better assess the branch loan portfolio. (4)

Hiring well-qualified officers was difficult for Northland at that time. Northland was not viewed as a particulary stable member of the banking establishment and it was considered to be a second rate institution by many Big Five bankers. Because of the history of management problems, relatively high turnover and its general reputation, it was difficult to attract quality personnel to the Bank.

Due to the extensive problems of which management was becoming increasingly aware, there was also a strong desire to promote from within to minimize the exposure of the extent of the problems to outsiders even though there was concern over the lack of experience and qualifications of some of the existing staff. As a result, the Bank commonly promoted existing staff to fill relatively senior positions within the Bank rather than seeking more experienced outside bankers. This policy also evolved from the belief that since conventional methods could not save the Bank, conventional bankers would not provide the solutions and that it would be better to rely on a young, aggressive and creative team to solve the problems. (6)

Immediately prior to Neapole joining the bank, a strategy for dealing with some of the Bank's problems relating to real estate had been developed by Fortier. Neapole was asked to evaluate and endorse the proposal to create a bank service corporation, Epicon Properties Inc., in his first few days with the Bank. After assessing Fortier and his proposal, Neapole gave his approval to one of the many stategies which were to be implemented during his term with Northland.

Epicon was devised by Fortier in conjunction with two real estate developers from Edmonton, Wieland Wettstein and Hal Walker. The initial concept arose from a number of loans where the bank was in the process of foreclosing, or had foreclosed on, properties where there were significant problems associated with the real estate. Dealing with the problems associated with real estate was consuming a large portion of the time of the account managers who had neither the desire or the experience to cope with the difficulties. Also, as loan officers were traditionally evaluated on the volume of new business they generate and not on their collection abilities there was little incentive for the account officers to focus on the problem accounts.

The Formation of Epicon Properties, Inc.

Fortier was introduced to Wettstein and Walker and the company which they managed, Ellesmere Developments Ltd., through a mutual business contact in early 1983. Ellesmere was (and continues to be) the real estate arm of, and is 80% owned by, Agra Industries Ltd. of Saskatoon, the second largest publicly traded company in Saskatchewan. Northland retained Ellesmere to assist with the management of certain real estate controlled by the Bank.

One of the first assignments was the management of a three hundred unit apartment complex in Grand Prairie, Alberta. The project had previously been owned by a company controlled by Nelson Skalbania and was little short of a complete disaster. The vacancy rate was approximately seventy-five percent, the police were called to the apartment two times a night on average, a German Shephard patrolled one of the boarded up units on a full-time basis. (6) It was clear that extraordinary measures would be required beyond the capabilities of an account manager. In addition to the tenant problems, some of the buildings were also sinking into the ground.

Ellesmere accepted the project on a fee basis with an option to purchase the project at the Bank's cost for a period of three years. The first step was to evict virtually every tenant, place an experienced project manager on-site and commence renovations. To alter the local perception of the project, the name was changed and local sports teams were given sponsorship under the new name. As a result of Ellesmere's efforts, the project underwent a complete turnaround and was almost completely rented by 1985.

Fortier was sufficiently impressed with the efforts of Wettstein and Walker that he asked them to evaluate the Cayman Island loan (previously mentioned in connection with Walter Prisco - see Chapter Four). During the lending boom, Northland had loaned approximately $6,000,000 to some road-builders based in Kitimat, British Columbia to finance the acquisition and development of a resort property on Grand Cayman Island in the British West Indies (7). According to sources in Cayman, these "developers" did little more than use Grand Cayman as a party destination, arriving in chartered jets. (8) Other than the title to the property itself and some rusted construction equipment, there was little to show for the funds which were to have been spent on development.

After examining the site and doing some investigation into the feasibility of developing a project, Ellesmere came up with a radical proposal to develop the property as a "short ball" golf course with a hotel and condominiums. Jack Nicklaus had reviewed the project and refused to design a nine hole course (there was insufficient land for an eighteen hole course), but had suggested that the project might be ideal for a course on which would be played a golf ball that flies only half the distance of a regular ball. As the owner of MacGregor, Nicklaus had been experimenting with the development of a short ball.

Armed with Nicklaus as the course designer and feasibility studies for a hotel and condominium developments conducted by Laventhol and Horwath, Ellesmere proposed that they would develop the project. The Bank, in return, was to be repaid its full loan exposure and would also be entitled to a 9% equity interest in the company formed to develop the project. Impressed by the originality and ingenuity of Wettstein and Walker and faced with the fact that to abandon the project and sell the land would have likely resulted in a substantial write-down or loss by the Bank, Northland agreed to provide the funding necessary to develop the project. (9) The final result (three years later) was the construction of the golf course, a 245 room luxury hotel managed by Hyatt and the first phase of a luxury condominium development of up to 450 units.

As a result of the efforts and initiative exhibited by Wettstein and Walker the discussion with Fortier soon turned to the possibility of formalizing the relationship between Ellesmere and the Bank. The concept was pursued and the result was the formation of Epicon with the Bank holding 55% per cent and Ellesmere 45% of the common stock. The company was only nominally capitalized with initial share capital of $100. The Bank was to pay a fee to Walsten Management Ltd., a corporation owned by Walker and Wettstein and all of the operating costs of Epicon. In return, Wettstein and Walker were obligated to dedicate the majority of their time and efforts towards dealing with real estate in which the Bank had interests, whether owned, loaned against or as proposed security. (10)

Epicon qualified as a bank service corporation under the Bank Act. The objectives in forming the corporation was to provide a vehicle and management to:

1) hold property foreclosed upon by the bank
2) develop, lease, sell the properties to maximize potential
3) advise the bank with respect to existing real estate loans where the security was marginal or the borrower weak
4) assist with the management of properties in receivership

5) act as consultants with respect to evaluating new real estate lending proposals

6) appraising real estate being held as security or owned by the Bank (or Epicon) (11)

The formation of Epicon enabled the Bank to transfer title to properties upon which it had foreclosed to a corporate entity which had the in-house expertise to maximize the recovery on the property. At the time Epicon was formed, there was a large number of foreclosures and foreclosure sales in the real estate markets in Western Canada. Typically, the foreclosed commercial properties had been neglected by the borrower (who usually tried to take as much cash out of the property before the bank either foreclosed, appointed a receiver or served an assignment of rents (where those remedies were available). By placing this type of property in Epicon the strategy was that Epicon would do whatever was possible to add value to each property prior to disposition. These activities were to include leasing, subdividing, renovating, packaging, re-zoning and marketing. By selling assets through Epicon, it was also hoped that the stigma of foreclosed assets (and the corresponding drop in value) could be avoided.

The strategy was also intended to free up a considerable amount of time of the loan officers. It is conventional wisdom in the banking industry that a problem account requires significantly more time and management than a current loan. By mid-1983, the loan officers were spending more time with troubled accounts than they were spending pursuing new business. Upon the formation of Epicon, the line bankers were to "go back to banking" to add sufficient good business to allow the Bank to outgrow its problems.

In July of 1983, Northland transferred $70,000,000 worth of mortgages, debentures (secured by real estate) and real estate to Epicon secured by non-cumulative preferred shares issued by Epicon. (12) The assets were re-appraised on the basis of their potential realizable value which assumed the application of the Epicon expertise. As a result of this new evaluation, the vast majority of the properties were transferred to Epicon at their book value (including interest, late fees and legal fees). Although the accounting for Epicon and the Bank was done on a consolidated basis, the "appraisals" done by Epicon allowed the bank to reclassify approximately $850,000 of interest which had been reversed in 1982 and between $2,000,000 and $3,500,000 in 1983 as it was now viewed as being ultimately collectible (13). Given that the reported profit before income tax (which was a recovery of in 1983) was $2,108,000, the Bank would have either reported a very small profit or a loss in 1983 in the absence of the reversals effected by the creation of Epicon Properties Inc.

These re-appraisals by Epicon proved to be very controversial. The fact of the re-evaluation and the values attributed to the assets were discussed at some length with the auditors in 1983 and they concluded that the approach and methodology was acceptable. It is important to note that Epicon never represented itself as a professional appraisal company. The properties were assessed on an individual basis and a plan was developed to maximize the value of each asset. The assessments assumed that the business plan would succeed and also stated the assumptions upon which they were based.

In addition to expecting Epicon to add value to the assets, it was the Bank's position that the reduction in value of most of the assets was due to extraordinary market conditions that did not amount to a permanent impairment in value (interestingly, this approach is consistent with the guidelines issued to financial institutions holding loan realization assets by the United States Comptroller of the Currency). (14) Also, conventional appraisals had proved to be extremely unreliable. Many of the Bank's loans had originally been supported by appraisals which indicated values five to six times apparent forced sale values, often only two or three years later.

The formation of Epicon was instrumental in maintaining at least the appearance of profitability in fiscal 1983. In addition to its functions in dealing with the real estate of the Bank, Epicon, through Walker and Wettstein were instrumental in assisting Neapole and Fortier formulate and implement the various strategies which were employed by the bank to solve its problems.

Senior Management Assessment and Recovery Team

Another of the strategies to be implemented by Northland management soon after Neapole joined the Bank was the the formation of the Senior Management Assessment and Recovery Team ("SMART"). SMART consisted of a task force of ten people and was composed of both Northland and Epicon management personnel. (15) As the majority of the problems (that had been recognized) at that time were real estate related, the senior management of Epicon assumed the leadership role in SMART. The strategy was designed to focus the attention of this group on the troubled loans. The administration of the problem accounts was changed from the account managers in the various branches to one of the SMART members. Although individual account responsibility was vested in the designated SMART officer, the group functioned as a team in trying to solve the problems relating to the accounts.

The formation of the team and the transfer of account responsibility was also designed to free the account managers from the time-consuming problem loans to enable them to pursue new, more profitable, business. Management had concluded that a different type of expertise was necessary in realizations and restructurings than for marketing and administration. Also, lending officers had previously been evaluated on the conventional basis of volume of new loans rather than on the administration of their portfolio or management of problem loans. As a result, they had tended to ignore the problem accounts and had concentrated on generating new business for which they received recogniton.

Funding and Expansion

As a result of the run-off of deposits experienced by the Bank in the wake of the Trust Companies affair, new emphasis was placed on obtaining retail funds. It was deemed essential to reduce the Bank's total reliance on the wholesale money markets and the standby lines of credits obtained from the Big Five. Also, the expansion of the Bank into the retail market dovetailed well with the plans to expand the operations of the Bank into Eastern Canada and to diversify lending both regionally and across various industries.

To minimize the costs of raising retail deposits the Bank decided to pursue the upper-class retail depositor through a system of "boutique" branches which provided executive class service in return for hefty fees or large deposits. In addition to providing large average deposits, it was anticipated that the Bank would be able to capture a high percentage of the high income market segment as this type of banking service was not being offered by any of the Big Five banks. The "Private Banking" system was launched in September, 1984. The branches were set up more like law offices than bank branches with formal reception areas where coffee was served to the clients if they were required to wait for their account representative to become available. At the Northland head office in Calgary, customers were even provided with valet parking while doing their banking.

The capital costs associated with opening new branches was also high, especially for an institution that was struggling to report profit each quarter. The cost of each branch was estimated internally to be approximately one million dollars and it required a large amount of time and effort to find the locations, complete the construction and staff the branch. (16) Epicon staff co-ordinated locating suitable premises, negotiated the leases and provided construction management.

There were other significant costs associated with the deposit gathering, however. As a newcomer in the retail market, the Bank had to pay interest at significantly higher rates than the larger, better established, institutions notwithstanding that the deposits (up to $60,000) were insured by the Canadian Deposit Insurance Corporation. The Bank was also competing with institutions such as Canadian Commercial Bank, Bank of British Columbia, Continental Bank and the small trust companies which were aggressively trying to raise retail deposits in Western Canada. As a result the interest rates paid by Northland were significantly higher than those paid by the Big Five.

At the same time as the retail operations were being expanded, the Bank commenced an expansion of its commercial operation into Eastern Canada. Management felt that it was critical to the survival of the Bank to diversify the portfolio both geographically and by industry. It was also felt that to be considered a viable Canadian bank it would be necessary to shed the image of being only a second-tier regional lender. As part of its expansion into new markets the Bank ventured as far as opening a Representative Office in Hong Kong in December, 1984. (17)

Expense Reduction

The Bank also sought to minimize expenses. Some of the overhead items, such as a high rental rate on relatively inefficient office space in Calgary (part of the Prisco legacy), could not be reduced due to local market conditions; however, there was an ongoing effort to reduce costs wherever possible. As a part of this drive, it was determined that staff reductions were possible even in the face of a large number of non-performing loans and a policy of rapid growth during a recession. Management felt that a highly skilled and well motivated group could accomplish the desired results more effectively and at a lower cost.

The objective was to operate a "lean and mean" bank in comparison to the other lenders. This was thought to be possible as the other banks were perceived by Northland management, many of whom had had some experience working for a Big Five bank, to be inefficient, unwieldy and highly bureaucratic. Additionally, a deliberate part of the overall strategy became to move the Bank towards merchant banking activities. Merchant banking was viewed as a potentially profitable market niche that was not being serviced by competing institutions.

To implement this stragegy, an evaluation of all personnel was conducted to determine where redundancy existed. Those officers that were not in favor of the overall strategies and changes or were not prepared to work extremely hard to achieve these goals were considered expendable. Although the Bank had historically been a low cost producer (based on assets per employee), it was felt that a further 25% reduction in staff could be effected without affecting the output of the organization. The primary rationalizations for this level of reduction were that the non-performing loan administration, which was very time-consuming, had been transferred to Epicon and SMART and the prospective merchant banking activities of the Bank would require fewer employees. The profitability per loan would theoretically be higher so the number of loans could be reduced. Previously, the number of employees had risen from 109 at the end of fiscal 1983 to 164 at the end of fiscal 1984. (18) This increase had been necessary to handle the large volume of new loans and to deal with the time-intensive problem accounts.

The Bank's objective was to reduce the overall number of employees and have a small, highly motivated and highly compensated lending group. Also, some of the workout strategies which were developed required the Bank to endure reduced income for a considerable period of time to ensure the repayment of the principal amount of the loan. The view was that the best way to compensate for this loss of income was to reduce expenses. In 1985, management began to implement the reduction strategy and approximately 25 employees (both management and staff) were dismissed or laid off.

CHAPTER EIGHT

The Effects of the Strategies

This chapter examines the financial results for fiscal years 1983 and 1984 and the apparent success of the strategies which had been implemented during that time. Changes to the Board of Directors and the Bank's stated strategic objectives are also reviewed.

1983 Results

In the 1983 annual report, Willson wrote that, "With some pardonable pride, we can report that our key objectives for fiscal 1983 have been met.". (1) Although the Bank had only achieved growth of assets of 14% compared with the forecast of 27%, earnings per share had improved over 1982 by 58%. Other key results noted by Willson were the successes in restoring nonproductive loans to income producers and the "creation of a new management team through recruitment and promotion. This has brought fresh confidence to the whole enterprise." (2)

At the end of fiscal 1983, 92.7% of the total loans were located in Canada and 54.5% were located in Alberta. International loans had continued to drop: from 8.6% in 1982 to 7.3% in 1983. Overall, the percentages had not changed significantly in comparison to those reported at the end of fiscal 1982. Total assets had increased by 14% to a total of $742.2 million. (3)

The 1983 results showed an improvement in profitability. Earnings per share had increased to $1.25 per share in 1983 from $0.79 per share in 1982. This improvement was attributed to, "...a significant reduction in non-interest expenses (other than premises costs), an increase in new quality business and an expanded funding capability.". (4) Return on average assets had increased from $0.31 per share in 1982 to $0.42 per share in 1983, although this was still considerably below the return of $1.14 in 1981. (5)

The Bank's loan loss experience increased from $2,775,000 in 1982 to $4,491,000 in 1983. (6) Neapole, who had been appointed President and Chief Operating Officer, wrote that the Bank's loan losses "...still vividly reflect the trials of the last two or three years.". He went on to say that, "Our current forecast for 1984 does not include significant increases in loan losses regardless of relatively aggressive growth targets.". (6) Non-productive loans had risen from $44.7 million in 1982 to $99.0 million at the end of 1983. (7)

The results of Northland reflected the concentration of loans in Western Canada. Although the Big Five also encountered large losses in the West, the impact was not as severe due to their diversified operations. (8) In 1983, average percentage of non-current loans to total loans was 4.05% for the Big Five, whereas Northland had the highest percentage of non-current loans of any of the Schedule A banks at 17.68%. (9) Notwithstanding the very high percentage of non-productive loans, Northland's provision for loan losses of 0.48% of average assets was slightly below the Big Five average of 0.49%. (10) Northland was also behind the Big Five in recognizing loan losses (as a percentage of eligible loans). Whereas the average of the Big Five was 1.14%, Northland reported only 0.70% of loan losses. (11)

During 1983, the Bank had opened its first Eastern Canadian branch in Toronto. This move was part of the implementation of the strategies of diversifying both geographically and by industry. In the second half of 1983, the Bank had begun to actively solicit retail deposits in an effort to lessen the reliance on the potentially volatile wholesale money markets. These efforts had resulted in increases of deposits of 78% or $111 million over 1982. (12)

Willson's comments in the 1983 annual report were far more general than they had been in the past. Rather than setting out specific objectives in terms of growth or business development, he dealt with matters on a more philosophical level. Some of the confidence displayed in prior years seemed to have disappeared. Willson wrote,

> Whatever sucess (sic) we can achieve in Northland will come from continuously creating new income, building our strength to survive downturns, sharing the earnings with those who make them possible, and living within our means. Our primary task is that of all business -- to create which can be shared after it is created. (13)

Previously, Willson had been quite specific in setting out the objectives for the following year. He had focused on specific areas which were to be improved and had often forecast growth targets and marketing objectives.

Although Neapole reviewed the 1983 operating results in more detail in the Annual Report, he provided few insights into the business plan although in his concluding remarks he stated that "... the employees of Northland Bank are enthusiastically executing a business plan that is ambitious, but feasible.". (14) The one objective which was emphasized was that of decreasing the reliance on money market funding. Neapole suggested that the strategy was to concentrate on direct deposits "...with a view to eventually having these sources count for well over 50% of the Bank's total funding requirements.". (15)

The comments of Neapole and Willson are interesting because they seemed to indicate a shift from attempting to communicate the Bank's objectives and strategies to dealing in generalities. Under Neapole, management operated quite independently from the Board of Directors and did not involve the Board in the day-to-day operations of the Bank or in the formation of strategies and policies. This independence was reflected in the tenor of Neapole's comments in the 1983 annual report. He did not disclose the nature of the business plan or the means by which the Bank hoped to achieve it (with the exception of raising direct deposits).

The Board of Directors - 1983

The Board of Directors did not change dramatically during 1982 and 1983. Of the 18 Directors at the end of fiscal 1983, 13 had been members of the Board in 1982, and one member, Alan Scarth, Q.C., had been Secretary and General Counsel to the 1982 board. The backgrounds of the six new members were fairly diverse: from brewing to development to practicing law. Notably, of the nine outgoing Directors in 1982 and 1983, three were associated with either co-operatives or credit unions. None of the new Directors in 1982 or 1983 representated any of these organizations. Only 3 of 18 Directors on the 1983 Board were connected with the co-operatives or credit unions compared to 9 of 14 Directors on the founding Board of the Bank. In the composition of the Board, the Bank continued to move further away from its "roots".

The function of the Board had also evolved over time. Initially, the Board had been active in setting policy and in making management decisions. By 1983, the Board had become more isolated from the day-to-day management decisions and policy-making. Typically, senior management would approach the Board for ratification of credit decisions or policy recommendations only where management did not have the authority to implement the changes without Board approval.

1984 Results

In the joint Report to the Shareholders of Chairman Willson and President Neapole in the 1984 Annual Report, they highlighted the formation of SMART and Epicon and the commencement of merchant banking and venture capital activities. (16) The creative activities of the Bank had even extended to the formation of a Native Banking Group "...whose mission is to develop banking services for Native Canadians across the country.". (17) The true objective of the formation of the Native Banking Group was to raise deposits and capital from some of the wealthy Western Canadian Indian bands.

The overall tenor of the comments of Willson and Neapole were very positive. They gave the clear indication that the workout efforts were being effective in reducing the non-productive loans and that the efforts to diversify, raise deposits, and attract capital were also being successful. (18) The Bank had expanded both nationally (to Montreal and Toronto) and internationally (to Hong Kong).

At the end of fiscal 1984, the loan portfolio had not undergone any significant change in the ratio of domestic and international loans, but some changes in the domestic portfolio had occurred. The portfolio had become even more concentrated in Alberta and the opening of the Toronto branch had resulted in loans being made in Ontario for the first time. Only 5% of total loans were in Ontario; 58% were in Alberta, an increase from 53.3% in 1983. (19)

The increase in the percentage of loans in Alberta had resulted from the restructing of a number of problem loans and from the new merchant banking activities of the Bank. In pursuing the objectives of growth and increased fee and interest income, the Bank had embarked on an aggressive lending campaign which had resulted in a number of new loans in Alberta, primarily secured by real estate and oil and gas assets.

During 1984, Northland had become a "billion dollar bank" in total assets. This momentous occasion was marked by a staff gathering, a champagne toast and commemerative certificates. At the end of fiscal 1984, total assets had increased by $338.5 million to $1,080 million. (20) Northland management had vigorously pursued the strategy of growth. Although the Bank had decreased its exposure in Western Canada in percentage terms, the dollar value of loans in the West had actually increased by approximately $261 million dollars or 71% of the amount of assets added to the portfolio in 1984. This expansion in the West was consistent with the strategy of pursuing perceived opportunity while other banks were trying to reduce their loans, however; it was contrary to the objective of diversifying risk geographically.

Net income had improved in 1984, rising to $3,347,000 from $2,945,000 in 1983. The profitability of the Bank had deteriorated in comparison to the previous year, however. Return on average assets had declined from .42% to .37%, return on average shareholders equity had slipped from 7.57% to 5.6% and earnings per share had dropped from $1.27 to 0.57. The reductions in the ratios relating to shareholders equity were attributable to 149% increase in the number of shares outstanding during the year. One particularly disturbing statistic was that the interest profit margin (net interest income as a percentage of average total interest-earning assets) had dropped from 3.05% in 1983 to 1.81% in 1984. (21)

The loan loss experience of the Bank had fallen from $4,491,000 in 1983 to $4,021,000 in 1984, and non-performing loans had dropped from $99.0 million to $75.2 million. (22) These statistics suggested that the Bank was beginning to solve the problems which existed in the portfolio and that the new loans were remaining productive. These improvements were attributed to, "Aggressive action, such as the formation of a special management team that concentrated on loan workout situations and the establishment of a subsidiary, Epicon, to manage problem loans related to real estate....". (23)

As a result of the rapid growth in loans and the changes in appraisal methods and accounting practice, the percentage of non-current loans reported in 1984 was 7.93% compared with 17.68% in 1983. (24) Over the same period, the percentage of non-current loans of the Big Five dropped from 4.05% to 3.65%. (25) In reality, there had been very few changes with the portfolio of problem loans at the Bank; the apparent improvement was due to the re-appraisals and the increase in loans, which reduced the non-currrent loans as a percentage of total loans.

Northland again reported loan losses that were below the Big Five averages. As a percentage of elegible loans, the Bank reported loan losses of 0.43%, down from 0.70% in 1983. The Big Five average also indicated some improvement: 0.87% compared with 1.14% in 1983, however, the 1984 level was more than twice that reported by Northland. Provisions for losses had increased for the Big Five, from 0.49% of average assets in 1983 to 0.55% in 1984. Northland showed improvement in this respect with provisions for loan losses declining from 0.48% in 1983 to 0.36% in 1984. (26)

Over the course of fiscal 1984 the share price had dropped from a high in November of 1983 of $7.25 per share to a closing price of $4.70 on October 31, 1984. The low for the year of $4.60 per share occurred in October of 1984. (27) Although the lower stock price might have been interpreted as a loss in confidence in the Bank's ability to generate profit (or reduce losses and non-performing loans), it is more likely that the stock price reflected the loan losses and continued high levels of non-accrual loans. Had the share price indicated an erosion in confidence, it seems unlikely that the Bank would have been successful in raising additional capital through a share issue, a fully subscribed rights offering, and a debenture issue in 1984. (28)

Northland had required a substantial increase in capital to support the massive growth and to provide protection against possible loan losses which would have resulted in reductions in capital. A private placement of shares occurred in November of 1983 which raised $17.18 million, a five year subordinated debenture was issued in February of 1984 in the amount of $15 million, and the one-for-four rights issue which closed March 16, 1984, raised an additional $8.0 million in capital. (29) Through these issues, the total amount of leverageable capital was increased from approximately $38 million at the end of 1983 to $77.2 million at the end of 1984. (30)

The Board of Directors - 1984

During 1984, four new Directors were added to the Board and four Directors departed. One of the outgoing members was associated with the co-operative group and none of the new members had any association with the co-operatives. The three new outside Directors (Neapole was the fourth) represented blocks of Bank shares that had been acquired as a result of the the share issues during 1984.

In previous annual reports, the Board of Directors had often been discussed as policy-makers and changes to the Board were often mentioned in the Chairman's or President's comments. In the 1984 annual report, there was virtually no mention of the Board or its activities. The focus was on management activities and the results of the previous year. Interestingly, for the first time when the Bank had a different Chairman and President, their report was issued jointly. It is the writer's opoinion that the report may have been written by Neapole or other members of management and that Willson had minimal input. This would have been consistent with the ever-increasing autonomy of management in 1984. There was very little day-to-day involvement by the Board and management was charting the course of the Bank and sought Board ratification only where strictly required. (31)

Objectives for 1985

In contrast to the 1983 annual report, in 1984 Willson and Neapole discussed some of the strategic objectives of the Bank for 1985. In their joint report they made reference to a business plan "...that is designed not to just solidify and bullet-proof the Bank, but to explore new and interesting markets and ways to generate earnings.". (32) It was clear from their comments that the Bank was evolving towards merchant banking. They further stated that, "In 1985 we will further develop off-balance-sheet income derived fron non-traditional banking activities which can be loosely described using the terms "merchant banking" and "venture capital".

The focus on merchant banking was the result of the chronic problems of the Bank with the non-performing loans. Normal spread business did not provide sufficient income to cover the costs of the problem loans or provide sufficient income and profits to recover past and pending losses. The interest profit margin (defined as "net interest income as a percentage of average total interest-earning assets" (33)) had fallen dramatically from a high in 1983 of 3.05% to 1.81% in 1984. This decline was attributed to the "...increase in our cost of funds which includes the carrying costs of the non-productive loans.". (34)

Merchant banking offered higher returns which were viewed as the way out of the crisis of the high levels of non-productive loans. The fact of the correspondingly greater risk seemed to always be ignored or discounted by management. As stated in the Report to the Shareholders, "A merchant bank lives by its wits more than by spread." (35) In the face of a deteriorating spread, the Bank was confident it had the wits.

Neapole and Willson also spoke of the success of the strategy to workout the problem loans rather than simply writing off the loan and disposing of the loans at "fire sale" prices. (36) The Bank would continue its emphasis on problem loans and real estate assets in 1985. They spoke glowingly of the successes of SMART and Epicon in implementing workout strategies and reducing the non-performing assets of the Bank.

In 1984, the Bank had sought to fund new growth by raising retail deposits. Although these deposits had increased to $753.4 million from $602.6 million, an increase of 25%, this was insufficient to match the explosive growth in the loan portfolio. According to the Vice-president, Retail Banking, the objective for 1985 was to increase retail deposits by 125% over 1984 levels. (37)

The overall tenor of the annual report in 1984 was very positive. Although non-productive loan levels were still high and the interest spread had narrowed significantly, the report was very optimistic and detailed the Bank's plans for the future in most of the divisions. The format was a glossy report which contained almost twice as many pages as in 1983. A detailed five year financial summary was also included which suggested that Northland was not afraid to show its results for 1984 in comparison with previous years. The 1984 reports may have been a bad omen, however; they literally came apart at the seams when opened.

It was clear from the comments of Neapole and Wilson that the original objectives of the founders of the Bank, however, had been almost completely abandoned in the struggle to survive. The only "need" the Bank sought to fulfill was that of its continued existence. The apparent plight of the Western Canadian businessman was no longer of any particular concern to Bank management except where the Bank could use it to its advantage to generate new loans (either conventional or merchant banking) with higher interest spreads and fees.

CHAPTER NINE

The Means to the End

This chapter evaluates some of the means by which the the strategies were implemented and by which the Bank was able to report desired results intended to maintain shareholder, depositor and regulator confidence in Northland.

Introduction

At the end of 1984, Northland management had avoided, or at least postponed, recognition of losses or potential losses to the extent that they were able to report results which suggested that the situation was improving at Northland. Although the results were below the cumulative industry averages, they did seem to indicate that the new management team was achieving some successes through the implementation of some of the new strategies.

As reported by Estey, the positive developments at the Bank by the end of 1984 included,

> ...the substantial growth in loan assets, the reduction of NPL [non-productive loan] levels, the increase in net income, the success of the retail deposit program, the generation of fees by the merchant banking group, the apparent workout successes including Epicon, the stabilization of loan losses, the slight improvement in the general

> economy, the elimination of interbank borrowings, and the successful preparation for a preference share and debenture issue scheduled for 27 March 1985. (1)

These results had been obtained through both aggressive management of the loan portfolio, increased lending and aggressive management of the income statement and balance sheet.

Valuation

According to Estey, Northland management did not apply conventional standards in assessing the value of loans or the ability of borrowers to repay the loans. (2) To do so would have resulted in additional loan loss provisions and write-offs that the Bank could not have survived. Estey concluded that, "By conventional standards the bank could have closed its doors sometime in 1983.". (3) Bank management chose to try to salvage the Bank through the implementation of the strategies discussed in previous chapters rather than declare insolvency. The effort to save the Bank required "...an adaptation of the concept of the "banker's final judgement" as to the ultimate collectability of the loan.". (4)

The Bank adopted a method of valuation of assets which took into account added value and future value. The added value was to come from work-outs by Epicon and SMART and the future value assumed an economic recovery in Western

Canada and increased values at some point in the future (typically, two to three years hence). These "values" were used in making decisions relating to both income recognition and establishing loan loss provisions. (5) The determination of these values was not based solely on these two factors, however.

In his testimony before the Estey commission, in answer to the question of whether the right number for provisioning income was the number that works, Neapole answered in the affirmative. (6) "Values" were apparently established in accordance with the value the Bank needed to show. With reference to adding value, Neapole testified: "...I guess the proof in the pudding is where you end up at the end of the day, assuming that you get to the end of the day.". (7) In other words, the end justified the means and Bank management was prepared to discard conventional standards to save the bank.

Management of the Loan Portfolio

In addition to utilizing creative valuation techniques, Bank management also changed the parameters for classifying loans as non-productive. The financial results in 1983 and 1984 suggested a stable or improving situation; however, this was accomplished by continuing to classify non-productive loans as performing on the basis of future security value that justified continued advances of interest by the Bank. (8) According to Estey:

> The magic wand was the workout. In the hands of management, loans which might otherwise move into the NPL category did not so move, with the beneficial consequences that capitalized and accrued interest continued to be recognized and provisions were avoided. (9)

Management justified the higher valuations as the workouts were presumed to add value and provide time for values to recover.

A number of witnesses appearing before the Estey commission testified that the financial statements should have reflected a "snapshot" of the true financial condition of the bank in accordance with generally accepted accounting practice (GAAP). (10) By applying the concepts of added value and future value, the Bank's statements were moving away from GAAP and accounting on a cash basis "...which the financial statements thereafter never reveal.". (11)

System Tolerance

Estey discusses two fundamental assumptions made by Northland management. Firstly, it was assumed that the economy would improve and future values would become real values and, secondly, that the regulators, auditors and members of the Board of Directors would allow the implementation of the various strategies and the changes to the accounting methods. (12) The latter factor was termed "system tolerance" by Neapole and it presumed that the groups involved were aware of the implementation of the numerous strategies and of the changes in the Bank's accounting methods and that these would be tolerated until the problems were solved. (13)

If the Bank had continued to use banking GAAP, a significant portion of the loan portfolio would have remained classified as non-productive and the Bank would have been unable to take the accrued but unpaid interest into income. On the loans that were re-appraised by Epicon, approximately $850,000 of previously reversed interest was reclassified as income in 1983. (14) A significant amount of interest which had been reversed in early 1983 was also reinstated as income later in 1983.

Estey concluded that the total reinstatement of interest income in 1983 exceeded "...$2M [million] (there is some evidence that the figure is closer to $3.5M).". (15) Given that the net income in 1983 totalled $2,945,000, the formation of Epicon may have made the difference of reporting a profit rather than a loss. Had the Bank reported a loss, it is probable that this would have caused funding problems. Raising additional capital would likely have been extremely difficult, if not impossible, had a loss been reported. Increased capital was essential to weather potential loan losses and to support the additional growth which was essential to the implementation of the other strategies.

Creative Financing

As part of the workout strategy, the Bank often placed 100 per cent financing on properties or assets it sold or refinanced. (16) In addition to this financing, the Bank would often authorize loan facilities to pay interest or to provide working capital for the development of the assets. Typically, where the authorized amount contained an amount for debt service, it was characterized as working capital. It was presumed that any additional actual funding (as opposed to capitalized interest) would result in added value to the property in excess of the amount advanced. By capitalizing the interest within the authorized limit of the loan, it could be taken into interest even though it was only accrued and not actually received.

The Bank also took fees into income even where the fees had also been loaned by the Bank to the borrower. This was justified on a basis similar to continuing to accrue interest past ninety days; management was confident that there was sufficient security to ensure all principal, interest, and fees were recovered.

CHAPTER TEN

The Effects of the CCB Bailout on Northland Bank

Although reporting and reality were diverging at Northland, management had succeeded in creating the impression of improvement at Northland in 1984. There were signs that the economy in the West was improving and the Bank was preparing to raise additional capital. In March of 1985, however, events at the CCB shook the confidence of the market. This external shock had a profound effect on Northland due to the similarity of the two banks. This chapter examines the CCB situation and the effects on the Bank. Press coverage and its impact on the Bank are also considered.

The Rescue Attempt

On March 25, 1985, it was announced by the Department of Finance that a financial support package had been arranged for CCB. Emergency funding was to be provided by six Canadian chartered banks, Canadian Deposit Insurance Corporation and the Alberta and Canadian Governments. Although the announcement was intended to provide assurances that the CCB and the rest of the Canadian banking system was in sound financial condition, the actual effect was that it shook the confidence of investors and depositors in CCB. The press release is reproduced in its entirety in Appendix III attached.

The immediate effect was that the wholesale (and uninsured) depositors of CCB and Northland immediately began withdrawing funds due to the uncertainty created by the CCB bailout announcement. Also, there was immediate focus upon Northland Bank by the press and analysts. Because of the similarity in the two banks from their origins to loan mix to growth patterns, the banks were often assumed to have the same difficulties.

The timing of the announcement of the rescue package for CCB was particularly bad for Northland. It had planned a share and debenture issue for the following week. As a direct result of the announcement, Northland temporarily postponed the issue.

The rescue package had been hastily constructed as a result of CCB advising the Government that it would be unable to continue operating without external assistance. After the rescue package was completed, the banks and governments involved demanded an audit of the situation. Unfortunately, upon closer scrutiny, it became evident that the problems within CCB were substantially greater than had previously been realized (and represented to the rescuers).

It soon became apparent that the rescue package had been too little, too late.

At the same time as the evaluation was taking place, some of the banks which had been members of the rescuing team were quietly withdrawing deposits from CCB, fearing that they might ultimately be lost if the bank failed. The withdrawal of these and other wholesale deposits required the Bank of Canada to meet the funding requirements of CCB in ever increasing amounts.

The press had focused on the CCB rescue and Northland was deemed guilty by association. It was presumed that the problems or situation at Northland must have been similar to CCB due to the similar loan portfolios and lending histories of the two banks. The effect on Northland was that analysts and depositors alike began to re-evaluate its financial status and confidence in the Bank began to weaken and the effects were immediate and severe.

Effects of the CCB Bailout Attempt on Northland Bank

Funding

The reliance on wholesale funding was an area of concern to senior management. As these deposits were not covered by the deposit insurance of CDIC, at the slightest sign of weakness these funds were likely to be withdrawn and would result in a funding crisis. Northland had already been paying a premium over and above the rates paid by the Big Five and it could not afford to significantly increase that premium because of the negative effect this would have had on the interest spread. Typically, the individual wholesale deposits were large amounts with short terms. As retail deposits tended to be less volatile (due to deposit insurance) and for much longer terms, they provided some of the stability required and also allowed the Bank to better match funding and lending because of the longer terms.

As discussed previously, after considering various methods of raising retail deposits, the Bank had commenced establishing a boutique retail branch system. At the same time, the Bank increased its marketing of retail instruments from its existing commercial lending branches. As demonstrated by the following table, the Bank had considerable success in raising retail deposits, although the interest rates paid were higher than those paid by the Big Five:

Table A

RETAIL AND WHOLESALE DEPOSITS 1980-1985 (1)

	WHOLESALE	RETAIL	TOTAL
October 31, 1980	227.3	.5	227.8
" " 1981	471.7	2.2	473.9
" " 1982	600.1	2.0	602.1
" " 1983	602.6	90.2	698.2
" " 1984	753.4	228.6	982.0
August 31, 1985	250	450	700

From the time of the Trust Companies Affair, Northland had maintained standby lines of credit with the Big Five banks. Immediately prior to the CCB rescue attempt, the Bank had been funded solely by its retail and wholesale deposits. After the CCB announcement, the deposit base started to erode and the Bank had to seek additional funding. In the past, the Northland had relied on the standby credit lines from the Big Five. When the lines of credit with the Big Five expired in June 1985, they were not renewed. Neapole stated both publicly and within the Bank that the lines had been allowed to lapse because the Bank of Canada had pledged its support and the costs of funding from the Bank of Canada was less than from the other banks. (2)

The actual reason for the lines of credit being dropped was that the banks were insisting on an inspection and additional security prior to the credit being renewed.

Northland refused to have the other banks inspect its portfolio (for what is now an obvious reason) and was unable to offer sufficient additional security to satisfy the other banks.

The bailout of the CCB caused a significant erosion of deposits at Northland. At the end of the first quarter in 1985, total deposits had risen to $1.048 billion and to $1.070 billion at the end of the second quarter. At the end of the third quarter of 1985 (July 31) total deposits had dropped to $803 million as a direct result of the effects of the CCB rescue attempt. (3) By August 31, 1985, the Bank of Canada provided funding support in the amount of $540 million. (4)

In spite of the fact that the retail deposits were only insured by CDIC up to $60,000 per depositor, Northland continued to be able to attract an ever increasing number of retail deposits until it was placed in curatorship on September 1, 1985.

As shown in Table A, retail deposits increased from $228.6 million on October 31, 1984 to $450 million on August 31, 1985. Of that $450 million, approximately $300 million was covered by CDIC insurance, with the balance uninsured. The following table sets out the mix of deposits held by Northland at the time of the appointment of the curator:

Table B

SIZE OF DEPOSITS HELD BY NORTHLAND BANK (5)
AS AT AUGUST 31, 1985

	NUMBER OF ACCOUNTS	$000,000's
Greater than $5 million	13	121.5
$2.5 - $5 million	14	48.1
$1.0 - $2.5 million	64	87.6
$500,000 - $1.0 million	85	62.2
$250,000 - $500,000	91	31.9
$100,000 - $250,000	311	42.5
$60,000 - $100,000	581	37.6
Less than $60,000	12,943	238.0
Totals	14,102	669.4

As Northland had allowed the standy lines of credit to lapse in June of 1985, it required funding support from the Bank of Canada:

Table C

BANK OF CANADA ADVANCES TO NORTHLAND BANK (6)
APRIL 1985 TO AUGUST 1985

April 30	$85 million
May 31	$119 million
June 30	$339 million
July 31	$378 million
August 31	$540 million

Management of the Bank and representatives of the Bank of Canada had a number of meetings to discuss the funding requirement of Northland. Initially, the Bank of Canada was not prepared to fund further growth, but the Northland executives persuaded the Bank of Canada that continued growth was essential as an integral part ot the strategies which were being implemented to improve the Banks situation. Ultimately, the senior officers of Northland were assured that the Bank of Canada would fund growth as well as existing requirements. (6) These assurances were given in July of 1985. Unfortunately for Northland, the assurances were not given in writing.

One of the side effects of the Bank of Canada agreeing to fund Northland's growth was that this angered the Big Five. By July 1985 the general feeling among the Big Five was that the CCB bailout had been too hastily put together, was ill-conceived and was quite possibly insufficient to ensure the survival of the CCB. The funding to Northland was also viewed as a form of bailout. Not only was it difficult to conceive that the central bank was going to permit growth, this funding was actually at a lower cost than Northland had previously been able to obtain from the Big Five under the lines of credit. (7) Estey indicated that the difference amounted to approximately one-half percent (8), however, according to the Toronto Star, in July 1985, the difference was 1.05% percent as the prime rate was 10.5% and the prevailing Bank of Canada rate was 9.45%. (9)

Additional Capital Issues

The rapid growth in assets in fiscal 1984 had created the necessity of raising additional capital. The Bank planned to go to the equity markets in early 1985. In late February, 1985 Northland filed preliminary prospectuses for the issue of convertible preference shares and floating rate debentures to raise an additional $35 million in capital. (10) The CCB bailout announcement came only one week before the Bank intended to go to the markets and the announcement necessitated the postponement of the issues.

In the aftermath of the CCB bailout and in the face of funding difficulties, Northland was successful in issuing $16 million of seven year floating rate debentures. (11) The issue closed on May 31, 1985. The initiative to raise additional capital by a preference share issue was permanently abandoned as a direct result of the problems at CCB. (12)

Public Perception and the Erosion of Confidence

Notwithstanding that Northland had successfully completed the debenture issue, the decline in deposits clearly indicated that the commercial markets were concerned about the stability of Northland. On July 10, 1985 it was reported on the CKO National News that:

> Nervous depositors have withdrawn large amounts of money from Calgary-based Northland Bank. Bank officials will not reveal the amounts involved or the extent of rescue cash they are now receiving from the Bank of Canada and other chartered banks. (13)

The news release went on to state that the April 30, 1985 financial statements of the Bank indicated that it had required $85 million in funding support from the Bank of Canada. The Bank refused to comment on the amount of funding it had required since that time. (14)

On July 11, 1985 the headline of an article in the Globe and Mail "reported" that: "Nervous depositors spur run on Northland". (15) The article was based on the same facts as the CKO report, however, the Globe and Mail declared that the funding by the Bank of Canada indicated a "run" on the Bank. The usually conservative Globe and Mail focused on the negative comments of analysts and omitted reporting any of the positive comments from the same analysts (which were picked up by other papers utilizing the same newswire source - CP).

The Globe quoted analyst Terry Shaunessy of Merrill Lynch Canada Inc. as stating that the size of the borrowings which might be revealed in Northland's next quarterly report "...could scare away even more depositors who fear for its insolvency." (16) The Edmonton Sun (perhaps compromising sensationalism for regionalism) reported that Shaunessy agreed that, although the Northland was much healthier, the depositors were associating Northland and CCB and quoted him as saying that: "It's not fair to lump the two of them together...but that's what has happened.". (17) The Globe and Mail omitted this and other significant mitigating comments of the analysts which were picked up by at least the The Edmonton Sun and The Vancouver Province. The reporting of the Globe is especially noteworthy given that the fact of the $85 million in funding from the Bank of Canada as well as the utilization of $200 million in standby lines of credit from other Canadian banks had been reported in the Calgary Herald on June 21, 1985.

The reports of a run on the bank prompted a newswire release by the Bank on July 12, 1985. In the release, William Kennett was quoted as being confident that the Bank would be able to mend itself due to good management and that: "It [Northland] has had an erosion of its wholesale deposits, but that's not a run.". (18) In the same release, Terry Shaunessy was quoted as stating that the Bank was "...suffering from fallout from the March 25th bailout of Canadian Commercial Bank, also a wholesaler." and that he was doubtful that a CCB type bailout would be required due to the management expertise of Northland.

The Provincial Treasurer of Alberta, Lou Hyndman also commented on the situation stating that "There is every indication of stability.". (19) There is evidence to suggest that the Provincial Treasurer truly believed in Northland; the Province had purchased $5 million of the $16 million debenture issue in May, 1985 and was the largest depositor with about $70 million on deposit with the Bank. (20)

The Final Days

After the flurry of press releases in mid-July, there was relatively little attention paid to the Bank by the press until mid-August when the Bank of Canada report was issued. The Globe and Mail reported on August 17, 1985 that the Bank of Canada had advanced a total of $1.8 billion as of August 7, 1985, double the average May advances of $903 million. (21) The article was picked up by the CP wire service and ran in at least two other papers in Canada, The Edmonton Journal and the Prince George Citizen.

On August 20, 1985 it was reported by The Calgary Herald that Northland had decided not to pay a cash dividend. (22) The article discussed rumours that the financial community were attempting to persuade the National Bank of Canada to take over Northland and also gave details on a recent sale by the Bank of a significant portion of its bad loans. The sale involved company called Rondix created by a former Director of the Bank and a prominent Calgary lawyer who was quoted as saying that the transaction "appears to have the support of the Bank of Canada,". (23)

The Rondix Deal

The Rondix deal is worthy of note for two reasons. It continues to be a source of argument as to whether the transaction was one of genius or one of folly and it is widely considered to be one of the actions by Northland that resulted in the appointment of the curator.

The transaction was fairly complex, but the concept was relatively simple. Rondix was to purchase $100 million of troubled assets and in return, the Bank agreed to lend Rondix a total of $131.25 million. Rondix was not required to contribute any equity and the loan was interest free. The additional $31.25 million was to provide $5.0 million in working capital and the balance was to be used to buy stripped municipal and federal bonds with a maturity value of $132.5 million. By this method of financing, the Bank was attempting to dispose of the troubled loans and while being assured of recovering the principal amount of the loan at maturity. (24)

Estey concluded that in trying to implement the Rondix transaction, "... Northland Bank was seeking to stretch to an absurd degree the rule that the carrying value of the loan need not take into account the time value of money.". (25) The Bank would have had difficulty surviving the recognition of the potential losses in the portfolio to be sold to Rondix. The sale and loan had the effect of amortizing the loan losses over the fifteen year term of the loan and as indicated by Estey, the generally accepted rule is that for non-accrual loans the cost of funds on the outstanding amount was not accounted for in calculating loan losses.

The Rondix sale solved the problem of preservation of capital (assuming that the concept could be sold to the auditors and regulators), however, it created a huge drain on income as the Bank would have to endure the cost of funds on the $132.5 million loan. Even at a cost of funds of 10%, this represented an annual cost of $13.2 million dollars. Management felt that this cost would be partially offset by income from the loan assets (to which the Bank was entitled) and through significant reductions in staff which would be possible after the disposal of the $100 million in troubled assets. The ultimate effect of the Rondix sale and loan will never be known because shortly after the transaction was announced, on the advice of the

Inspector General of Banks, the Bank of Canada withdrew its support and Touche Ross Limited was appointed curator of Northland Bank.

CHAPTER ELEVEN

The End of System Tolerance

The appointment of the curator was the beginning of the end for Northland Bank. This chapter examines the sequence of events from the time immediately prior to the appointment of the curator to the appointment of the liquidator in January, 1986.

Introduction

The description of the events that occurred over the Labour Day week-end of 1985 are based on the writer's recollections from that time. The writer was kept informed on an hour-by-hour basis but no notes were taken. The information was received second-hand at the time so the accuracy may have suffered somewhat in communication. Notwithstanding these qualifications, the following is believed to be substantially correct.

The Appointment of the Curator

Late in the afternoon of Friday August 29, 1985, Chairman Willson received a telephone call from an aide to Barbara McDougall, Minister of State for Finance. The purpose of the call was to advise Willson that he and the other most senior members of the Bank were required to be in Ottawa the following morning at 9:00 o'clock for a meeting with the Minister. The purpose of the meeting was not disclosed. Due to logistical difficulties with commercial flights, a jet was chartered (which was not the usual means of travel for Bank executives) and arrangements made to pick up Alan Scarth, the Bank's General Counsel, in Winnipeg.

Due to mechanical problems, the Northland group, which consisted of Willson, Neapole, Fortier and Scarth, did not arrive in Ottawa until 3:00 pm.on August 31, 1985. Upon their arrival, they were placed in a conference room to await the arrival of the Minister. Over the course of the next few hours numerous aides and bureaucrats attended at the conference room but nothing concrete was discussed. Finally, Fortier advised one of the aides that unless the meeting with the Minister was commenced immediately, that the group would leave.

The Northland group was advised that a liquidator was to be appointed for the CCB and that the government also wished to appoint a liquidator for Northland. A prepared press release announcing the appointment of liquidators for both CCB and Northland was shown to the bankers and the representatives of the government indicated that they wanted the consent of Northland management so that the press deadline for that day could be met. The Northland group was stunned. They had had no forewarning that this was the agenda of the meeting or that this was the objective of the government.

The Northland group immediately advised that they had no intention of consenting to the appointment of a liquidator and, further, that they did not have the authority to consent even if they were inclined to do so. They asked that they have some time to further consider their position and to consult other members of the Board and management. During the adjournment they contacted other members of senior management in Calgary to discuss the state of affairs.

Upon reconvening, the bankers advised they would fight the appointment of a liquidator. The representatives of the government were very displeased and indicated that if the consent was not received they would expose the affairs of the Bank and, it was implied, ruin each of them personally. After additional calls to Calgary, it was decided that no consent would be forthcoming; management took the position that there was nothing to hide (and therefore nothing for the government to expose) and they were not prepared to make it easy for the government. As a direct result of the resistance of management, the interim measure of appointing a curator was taken.

Touche Ross Limited was appointed curator on September 1, 1985. The government indicated that the curator had been appointed to provide Northland with an opportunity to reorganize its affairs or find a merger partner. The Department of Finance also appointed R.E. Bellamy, an investment dealer, to "assist" Northland in reorganizing its affairs. (1) Although the government went through the motions of appearing to be willing to give Northland an opportunity to survive, the criteria which were established for an acceptable plan of reorganization (see below) made reorganization highly improbable, especially after the appointment of the curator. Northland was no longer a going concern.

The Reorganization Attempt

The assets of the Bank were now viewed on a liquidation basis. The curator embarked on an assessment of the loan assets (with the assistance of officers from the Royal Bank). The evaluation was similar to those conducted by the OIGB in August. At that time the OIGB had reported to the Minister of State (Finance) that on a "fast liquidation basis" there would be a probable loss in the order of $300 million. (2) On this basis, virtually every chartered bank in Canada would have been insolvent in

1985. Had the banks been required to liquidate even the sovereign loans and loans in Western Canada (including corporate loans such as to Dome Petroleum), in all probability this would have severely strained or, in most cases, eliminated capital reserves.

During the week of September 15, 1986, Neapole was invited to Ottawa by a ministerial aide for meetings. He was told over the phone to "Bring your party tie" which he interpreted as meaning there was good news pending (in retrospect perhaps it meant Progressive Conservative Party tie). In any event, he flew to Ottawa where he was subjected to numerous meetings with senior bureaucrats and hours of waiting. He began to suspect that he had been called to Ottawa to get him away from the Bank and there were rumours circulating that an application for a liquidator might be imminent.

Neapole returned to Calgary where he and Fortier held a press conference on September 20, 1985, breaching instructions of the curator to not talk to the press. During the conference, Neapole and Fortier stated that they felt that the government was not dealing in good faith and that they were making a last minute plea to all interested parties as they believed liquidation to be imminent (Neapole said that he wanted to speak from his soapbox while he still had one). Neapole accurately described the reality of curatorship: "In truth, it is quasi-liquidation. It is not possible to restructure or arrange an amalgamation coming out of curatorship.". (3) This complaint was also an accurate prediction: the government announced its intention to liquidated the Bank 10 days later.

In a press release dated September 30, 1985 from the Department of Finance, Barbara McDougall announced that an application was to be made under the Winding Up Act for the liquidation of Northland Bank. (4) The release quoted McDougall as being disappointed that the attempts at reorganization had been unsuccessful. She confirmed that a number of proposals had been received, but that they all failed to meet the minimum criteria established by the Government. A portion of the final report of the consultant to the Department, R.E. Bellamy, was repeated:

> In our opinion none of the proposals which we have examined or discussed meets the essential objectives of (i) effectively limiting the Government's risk exposure, and (ii) providing a sufficient degree of certainty that the refinancing restores the Bank as a viable financial institution. Furthermore, our examination to date does not provide reason for optimism that in the circumstances, any of the proposals can be implemented within an acceptable time period.

It was never made clear what was an acceptable term. The feeling of management was that the government was simply trying to placate them and create a favourable image with the press and the public.

The other limiting conditions imposed by the government made reorganization highly unlikely. The appointment of the curator had eliminated the remaining market confidence in Northland. To restore confidence would have required the unconditional committment or guarantee of either the government or one of the Big Five banks (or by that time the Big Six including National Bank which had had a cursory look at Northland prior to curatorship and had breached a confidentiality agreement by subsequently announcing that they had looked at, and were not interested in, Northland).

The Appointment of a Liquidator

Immediately after the announcement by the government that it would be seeking the appointment of a liquidator, Northland management struck back. In a press release issued the same day as the government announcement, the Bank questioned the objectivity of the curator, Touche Ross Limited. (5) The release stated that the curator's bill for the first month was anticipated to be in excess of $1 million. Also, it appeared that the government intended to appoint Touche as liquidator; if the conclusion was to liquidate, Touche stood to make millions of dollars in fees over a considerable term (it is the writer's opinion that the government should have excluded Touche Ross Limited as a prospective liquidator to ensure objectivity). On October 1, 1985, Bank management informed the press that it would be opposing the government application to appoint a liquidator. (6)

On October 4, 1985, the Canadian Deposit Insurance Corporation applied to the Manitoba Court of Queen's Bench for the appointment of a provisional liquidator (the titular head office was still Winnipeg). Mr. Justice Kennedy ruled that Touche Ross Limited had sufficient power as curator to deal with the situation at the Bank until meetings of the creditors and shareholders could be held. November 14, 1985 was suggested as a possible date for these meetings to be held. (7)

The meetings of the shareholders and creditors on November 14 were a fiasco. After repeated attempts to exclude everyone other than actual creditors and shareholders or their authorized proxy holders, which attempts included threats to bring in the police, the meeting was moved to another room and each participant had to provide documentary proof of status before being allowed into the room. Once order was achieved, the meetings were relatively brief. Representatives of the Bank of Canada and the Canadian Deposit Insurance Corporation (CDIC), as the largest creditors, nominated and passed the motions to have Touche Ross Limited appointed as liquidator of Northland Bank.

After this meeting, the fact of liquidation appeared inevitable even to management which had continued to try to find some means to salvage the Bank. An application for the appointment of the liquidator which was set for early December was postponed until January 20, 1986 at the request of the CDIC. The application was heard on that day and the Touche Ross Limited was appointed liquidator of Northland Bank. Pursuant to the terms of the Liquidation Order, all employees of the Bank were terminated as of that date. Only a few days before the appointment, R.A. Willson had retired as Chairman of Northland Bank.

CHAPTER TWELVE

Reasons for System Tolerance

The bailout of the CCB had focused a great deal of attention on Northland. Although the Bank had been successful in producing financial results which appeared encouraging, under closer scrutiny, it became apparent that some of the methods employed by the Bank were only delaying inevitable losses and that the workout plan was largly effective in only deferring or disguising the problems rather than providing actual solutions. This chapter considers some of the reasons why the creative and aggressive workout strategies employed by Northland were tolerated by the Board, the regulators and the auditors.

Introduction

Some of the workout strategies implemented by Northland Bank were considered very agressive and, like the Rondix transaction, pushed banking and accounting conventions to the limit (or perhaps beyond). Notwithstanding this fact, management took steps to keep the Board, the auditors and the OIGB apprised of the methods utilized. It is the writer's opinion that management genuinely believed that all these groups were aware of the numerous creative solutions being implemented. It is certain that the overseers did not fully understand all of the strategies and transactions (and the necessary ramifications of putting them into effect), however, the evidence suggests that the significant strategies and transactions were presented by management to these groups. Based on the writer's experiences, it also seems clear that although management made these presentations, that it was more concerned about fulfilling the various requirements to provide information than in ensuring that the transactions or strategies were actually fully understood or in seeking feedback or instructions.

Internal Inspectors

Although Northland created an internal inspection system in 1978, the Chief Inspector (which position was created by Prisco in 1981) was never given the mandate or authority to have any real effect on the way the Bank conducted its business, classified loans or established loan loss provisions. (1) Management instructed the successive inspectors not to concern themselves with the loan portfolio but rather to deal with loan administration and accounting procedures. (2) Iain McLeod (whom Neapole had had to convince to stay with the Bank) was asked to stop circulating his reports to senior management, the auditors and the Audit Committee of the Board. (3) Estey praises the efforts of the Inspectors, while acknowledging that they were relatively powerless. There is no explanation offered as to why the Audit Committee did not react to the cessation of reports from the internal inspectors. According to Estey, the external auditors felt the powers of the Chief Inspector were so limited that any findings were of no use to them. (4)

There is an argument that an internal inspection system is not necessary in a small institution where management is familiar with the loan portolio. There is no formal requirement to maintain this type of control, however, it could certainly be argued that if Northland had given the Chief Inspector some authority over the establishment of loan loss provisions that the evolution of the Bank might have been different. As it turned out, the reports of the Chief Inspector were of little use except to provide a retrospective internal view for the Estey Inquiry.

The Board of Directors

In his report, Estey concluded that the Board of Directors assumed very little responsibilty for the operations of the Bank and relied "very heavily" on management to run the Bank and on the auditors to monitor the conduct of management. (5) As a result, Estey wrote that, "There seems in all this to have been little left for the Board itself to do as an element in the government of the corporation.". (6)

Estey also concluded that the Board was well aware of the workout efforts of management including the formation of Epicon Properties Inc. in 1983. (7) Notwithstanding that the transactions were presented to the Board, at least in general terms, Estey concluded that,

> It is abundantly clear that the Board, or certainly its majority, did not have a grip on the survival tactics of the bank in its last three years, or their consequences. It is less clear, but still probable, that their knowledge of the lending policies in the first era of the bank was equally incomplete. (8)

Management did not encourage Board involvement in the operational decisions. It was clear to the writer that management felt it was necessary to keep the Board informed and to seek its approval on major transactions and strategies but that management deliberately sought to isolate the Board from operational decisions and from strategy formation. Estey cites an attempt by one of the Directors, Thomas Assaly, to obtain some answers relating to operations. Assaly's inquiry was rebuffed through Neapole and the reaction by management was described by Estey, "...as a rejection of this kind of inquiry as evidencing a desire by a Director to get into management instead of confining himself to broad questions of policy." (9) Estey also concluded that the Board was persuaded or sold on the various strategies by management which was technically qualified and quite convincing. (10)

The Audit Committee

Under the Bank Act, the appointment of an Audit Committee is mandatory. The duties of the Committee are set out in section 243 (3) of the Act :

> The audit committee of a bank shall review the annual statement and any other financial statement of the bank that may be required by the by-laws to be submitted to the shareholders before such statements are approved by the directors.

The mandate of the Committee is not set out in the Act; however, in most banks the Committee performs an internal audit function to ensure that the statements are accurate and that the provisions for loan losses are adequate. (11)

Like the Board in general, the Audit Committee took the position that management was responsible for establishing loss provisions and, if the external auditors were satisfied, this was sufficient scrutiny. (12) Estey concluded that the Audit Committee had direct exposure to the levels of provisioning and to internal challenges to the provision levels established by senior management. He also concluded that the Committee was aware of the practices of management with respect to income recognition yet it did not require management to justify its actions. (13)

Rather than challenging management to justify its practices, the Committee obediently supported the efforts of management. Estey cites an example where, the Committee disagreed with the auditors on the basis that it was important for the Bank to maintain as "good a picture as can be justified" in view of the market and problems small banks were having. (14) Additionally, the Committee met infrequently which provides further evidence of the relatively casual approach to fulfilling their obligations. In 1984 ~~the~~ Committee met only twice and in the 10 months of 1985 (prior to curatorship), they only met one time. (15). This is especially remarkable given the facts of the attempted capital issues, the CCB bailout and the erosion of the Bank's deposit base, all of which occurred prior to the appointment of the curator in fiscal 1985.

Loans from the Bank to various Directors may have also directly or indirectly affected the impartiality of the Board. The Estey report sets out the details of Director borrowings in the final year of the Bank; 6 of the 14 Directors had a total of $7.5 million in loans outstanding. (16) Officers of the Bank (and Epicon) were also heavily indebted to Northland. Loans in the amount of $2.1 million were outstanding when the curator was appointed. (17)

The Auditors

The Estey Inquiry explored in considerable detail the duties and standards of the external auditors. Due to the limited scope of this paper, emphasis has been placed on the the conclusions reached by Estey rather than on the standards which should have been applied by the auditors.

The Bank Act requires that two accounting firms act as auditors of a bank. The auditors which were appointed by the Northland Bank in each year were as follows:

Table D

NORTHLAND BANK AUDITORS 1976 - 1985 (18)

	Lead	Second
1976	Thorne Riddell	Touche Ross
1977	Thorne Riddell	Touche Ross
1978	Touche Ross	Thorne Riddell
1979	Touche Ross	Deloitte Haskins + Sells
1980	Deloitte Haskins + Sells	Touche Ross
1981	Deloitte Haskins + Sells	Thorne Riddell
1982	Thorne Riddell	Deloitte Haskins + Sells
1983	Thorne Riddell	Clarkson Gordon
1984	Thorne Riddell	Clarkson Gordon
1985	Thorne Riddell	Deloitte Haskins + Sells

In general terms, the primary responsibility of bank auditors is to satisfy themselves that the financial statements prepare by management accurately reflect the true financial condition of the bank at the time of the audit. (19) The statements are to be assessed in accordance with GAAP and the provisions of the Bank Act (see section 242). (20) GAAP is dictated by and codified in the Canadian Institute of Chartered Accounts Handbook. Where the audit is conducted by two accounting firms, the responsibility for the audit opinion is shared equally. (21)

Bank audits are conducted once a year. The annual financial statements are a "snapshot" of the financial affairs of a bank at year end. Typically, the auditors have little other involvement with a bank unless an opinion is required in connection with a public offering or for some other special purpose.

As in the case of the CCB, the individual auditors had no direct bank audit experience. (22) This may have been a function of being the only banks headquartered in Alberta (at least until the formation of the Bank of Alberta). The local auditors communicated with other offices and auditors of their firms to gain the benefit of other bank audits (23). This lack of direct experience, however, raises questions about the auditors ability to adequately evaluate Northland's policies and practices in a banking context.

One of the most important issues relating to the audit was the acceptance of the "future value" concept of valuation. Rather than evaluate security of a present market value, the Bank utilized methods termed "investment value" or "added value" which took into account expected increases in value through the expected recovery or "normalization" of the markets or through the application of the expertise of SMART or Epicon. (24)

Estey is very critical of the auditors relying "pretty heavily" on the expertise of Walker and Wettstein in determining values. (25) He points out that Walker and Wettstein were not objective third parties due to their relationship with Northland (including loans) and concludes that, "...their statement as to value, whether correct or not, should not have been relied upon by the auditors.". (26) It should be noted that Walker and Wettstein did not hold themselves out to be real estate appraisers nor did they pretend to have an arm's length relationship with the Bank. Notwithstanding Estey's conclusion that the auditors should not have accepted these valuations, it is clear that both the auditors and the Office of the Inspector General (OIGB) were aware of the methods being utilized by Northland. As set out in OIGB files and reported by Estey,

> ...The auditors stated that the bank does not lend money with the idea that it can get it back almost immediately, Rather most of its loans will take three or more years to come back. In this regard Northland is probably different from other banks. Recognizing this, the auditors do not take a forced liquidation approach to valuing security and loans.

> They listen to management's plans and expectations for each situation. Where liquidation was the approach assets were valued at current prices. Where the bank looked upon the situation as a workout or longer term hold, future values were used. (27)

Although the quote is lengthy it is important in establishing both that the auditors were aware of the approach being taken by Northland management and that the OIGB did not object to the approach.

Estey raises the issue of whether the OIGB "authorized" this accounting treatment. Irrespective of whether the OIGB explicitly authorized these methods, the fact that it did not object could only be interpreted as tacit approval. It was reasonable, therefore, for both the auditors and management to have continued to use these methods. The important issue which arises, however, is whether the financial statements accurately reflected the use of these unconventional methods of loan and security valuation.

In 1983, the Bank made a significant change in its policy regarding accruing interest. Previously, the Bank had adhered to the industry convention of placing a loan on non-accrual when interest was 90 days in arrears. The policy was amended such that the Bank continued to accrue interest after 90 days if there was a workout plan in effect, sufficient security existed to cover principal and interest and the borrower was meeting its obligations for payments under the workout arrangement. (28) In applying this policy the Bank also re-evaluated assets acquired previously through foreclosure and took accrued but previously unrecognized interest into income if the value of the asset was deemed to be sufficient to also cover interest. (29) This was the application of the "future value" method in determining value.

In his testimony before the Estey commission, a partner of Thorne Riddell, W.K. Detlefson, affirmed that if a workout was in place and the plan was adjudged to be reasonable and it appeared that the loan would eventually be worked out that this was sufficient basis for concluding that no loan loss provision was necessary. (30) This treatment of loan loss provisioning was inconsistent with conventional banking practice in Canada. Most banks establish a prudential reserve for any amount which is deemed potentially uncollectible based on present market value.

In their testimony before the Estey inquiry, line bankers as well as the Presidents and CEOs of large Canadian banks testified that they had never seen "future values" used (which one expert described as unreasonable and unrealistic) and that reserves should be be based on conservative estimates of realizable value. (31)

Estey concludes unequivocally that the auditors were,

> familiar with the management policies with reference to the workouts and were fully aware that the bank founded its program of income recognition and loan loss provisioning on the employment of predicted workout values and future values. (32)

He also found that management in no way interfered with the audit process and that the auditors, who exceeded their time budgets in the 1983 and 1984 audits, had ample opportunity to review the bank records. (33)

It is clear from Estey's conclusions that the auditors were aware of the policies and practices of Northland management in their efforts to solve the extensive problems with the loan portfolio. It is also evident that the auditors had actual knowledge of the situation at the Bank and that the accounting practices of the Bank changed dramatically in 1983 resulting in much less conservative loan loss provisions and income recognition than in prior years. The further conclusion made by Estey is that the changes in the accounting procedures and in the financial condition of the Bank were not reflected in the financial statements of 1983 and 1984. (34)

According to Estey, had the auditors applied the conventional standards of bank auditing, they would not have approved the financial statements of the Bank in 1983 and 1984. If these standards had been applied,

> The Northland Bank would have been insolvent and identified publicly as such prior to 1 September 1985. The financial statements of fiscal year 1984, if prepared in accordance with the policies of accounting and bank auditing principles ..., would have disclosed that the bank was insolvent at that time in the sense that it would have had a negative net worth. (35)

Estey also concluded that, in all probability, the same result would have occurred in 1983 but that this could not be positively concluded on the evidence before the Commission.

Although partially redundant, the following quote from the Estey Report clearly indicates the unqualified nature of the conclusions reached by Estey with regards to the auditors:

> The Northland Bank statements did not, on the basis of the information revealed in this record, fairly present the financial position of the bank at the 1984 fiscal year end, and probably at the 1983 fiscal year end as well. Accordingly, the auditors should not have issued their certificate of approval of these statements for 1984, and probably should not have done so for 1983. This is not an assessment of circumstances exercised in hindsight and based upon loan reviews after the appointment of the curator, but rather a judgement which must necessarily be passed on the basis of the record as revealed and known to the auditors by 31 October 1984. (36)

The final sentence is surprising in that Estey appears to be anticipating, and responding to, the criticism that his analysis was retrospective and therefore not valid with respect to how the auditors should have conducted themselves at that time. Although his mandate was not to establish liability, the above statement may have been intended to be used for that purpose in subsequent legal actions taken to determine liability.

Although the lack of bank audit experience may provide a partial explanation for the conduct of the auditors, it is clear that they understood that Northland management was not following banking conventions in both operations and accounting. This suggests that there must have been other reasons why the auditors were prepared to sign the statements in the face of the changes and the actions of management. The tolerance of the OIGB appears to have been one of the major influences on the auditors. The interaction between the auditors and the OIGB is discussed in the following section on the OIGB.

The Office of the Inspector General of Banks

Section 246 of the Bank Act outlines the primary responsibilities of the Office of the Inspector General of Banks. The Inspector General reports to the Minister of Finance and has the status of a Deputy Minister. (37) The Inspector General is responsible for the general administration of the Bank Act and is required to "...inquire into the affairs of each bank at least annually so as to satisfy himself that the provisions of the Act regarding the safety of the the interests of depositors, creditors, and shareholders are observed ..., and that the bank is in a sound financial condition." (38)

A written report is submitted to the Minister after the annual inspection. (39) In their submission to the Inquiry, the 1984 auditors indicated that in their view the Inspector General could be considered as "the third and most senior auditor in addition to the two statutory shareholder's auditors.". (40)

A bank inspection is conducted in two stages. In the initial stage a questionnaire is generated by the OIGB and provided to the bank and from the responses and other information previously provided , the OIGB prepares a pre-inspection report. (41) This report forms the basis for an on-site examination of the bank where the principal concerns are "... capital adequacy, asset quality, management quality, earnings, and liquidity.". (42) Due to manpower constraints, inspection is typically conducted by two or three inspectors for a period of one to four days and in the case of domestic banks the Inspector General or the Assistant Inspector General usually attends at the bank prior to the conclusion of the on-site inspection. (43)

Although the OIGB is provided with information throughout each year, the actual inspection process, as outlined above, is very limited. The resources available to the Inspector General in 1983 and 1984 did not permit a more detailed analysis of each bank. According to Estey,

> It is clear that the Inspector General, in discharging his duty under the Bank Act to examine and inquire into the business and affairs of each bank, relies heavily upon the external auditors of the bank for the financial information relating to the bank's operations and particularly relating to the state of the loan portfolio. (44)

Conversely, the auditors claimed that the OIGB had numerous conversations and received many documents during the course of the year to which they were not privy. In their submission to the Inquiry, the auditors for 1984 outlined 40 discussions or communications of OIGB staff with numerous parties relating to Northland problems as evidence that the OIGB was both well informed outside of the formal external audit process and that it possessed information that was unavailable to the external auditors. (45)

Accepting the conclusion of Estey that the OIGB relied heavily on the conclusions of the external auditors, it is interesting to note that Estey goes on to state that,

> The external auditors in turn rely upon the management of the bank who prepare and present in the first instance the financial statements. (46)

The end result appears to be that the OIGB relied on the auditors who, in turn, relied on management and that management kept both the auditors and the OIGB relatively well-informed as to the policies and practices of the Bank including the workout strategies, accounting changes and the method of valuing assets. It is not surprising that management felt that there was system tolerance although it may have been, in fact, analagous to the sculptures of the three monkeys: management spoke no evil, the auditors saw not evil and the OIGB heard no evil. The system tolerance may have been by default rather than through conscious policy decisions.

According to the submission of the auditors, it was clear from the evidence before the Inquiry that the OIGB had detailed knowledge of workouts including all the Epicon loans. (47) This conclusion is supported by Estey who states that the Inspector General, "... commencing in 1982-83, became aware of the survival tactics adopted by management, including primarily ... using undiscounted future values ....". (48) Estey goes on to state that the process may not have been fully understood by the OIGB but that it was understood that a gap existed between the market value of the assets and the perceived future value used by the Bank. (49)

The lack of understanding of the ramifications of the Northland strategies coupled with the acquiescence of the auditors to the plans implemented by management seemed to lull the OIGB into a state of complacency with respect to the Bank. As observed by Estey,

> ... the OIGB did not effectively bring its investigative and statutory powers to bear on the problem soon enough. The evidence was before the inspectors at least before the end of fiscal 1984, and probably in fiscal year 1983, to draw the curtains on this bank before it had damaged those many businesses and persons who came to deal with it. (50)

The testimony of the Assistant Inspector General, D.M. Macpherson, in response to the question of when the Inspector General first became aware in detail of the workout program at Northland, was, "I think that back in 1983 we were prepared to see and live with the bank in an attempt to get through this period [of recession].". (51) The OIGB appears to have been relying on the lack of concern by the external auditors and the external auditors took the positon that because the OIGB appeared to be satisfied with the state of affairs at Northland, no further action was required.

To further rebut the allegations that the OIGB was dependent upon the external auditors, in their submission to the Estey Inquiry, the 1984 auditors also stressed that "... the OIGB and the Ministry of Finance were the only bodies who had the power to stop the Bank's continuing its course of action.". (52) Although technically correct, had the auditors refused to certify the statements of the Bank in either 1983 or 1984 or had they included extensive footnotes to the statements detailing reservations about the practices and policies of the Bank, the Bank would have had to alter its strategies or reporting practices. Maintaining market confidence would have been much more difficult.

Although a number of witnesses who appeared before the Estey Inquiry described the auditors as an integral part of the system which tolerated the Bank's actions, the auditors submitted that they relied on the system tolerance as opposed to providing a part of it. They argued that the necessary tolerance could only have been provided by the OIGB or the government. (53) They contended that their audit opinion was predicated on the assumption of the Bank continuing to operate as a "going concern" and that the Bank required the tolerance of the OIGB and the other governmental agencies for that assumption to be correct. (54)

The Bank of Canada and the Ministry of Finance

In terms of inspections or audits, the Ministry of Finance, the Bank of Canada and the Government are essentially treated as one entity for the purposes of this paper. The primary inspection responsibility for all the above groups resides with the OIGB. The fundamental difference between the above groups and the OIGB is that the mandate of the OIGB does not include making policy or political decisions: this is the domain of the Ministry, the Bank of Canada and, of course, the government itself.

CHAPTER THIRTEEN

Conclusion

This chapter examines the original objectives and concept for the formation of Northland Bank, summarizes the reasons for failure, reviews the reasons why the system "tolerated" the continued existence (and support) of the Bank after 1983 and considers some other factors which may have influenced the Bank of Canada, the Ministry of Finance and the Government of Canada prior to the appointment of the curator.

The Founding Objectives

It is difficult to draw general conclusions due to the unique character of the Bank, its leaders and the unusual economic conditions which prevailed during its existence. The fact that both the CCB and Northland failed is strong support for the conclusion that the concept was ill-fated from the beginning, yet this cannot be concluded without reservation. Perhaps neither the CCB nor Northland could have survived had the economic environment been different or if the banks had been able to attract different leaders whose strategies were better suited to the situation. Both institutions were managed aggressively and expanded very quickly during the period of rapid economic expansion in the West.

It might be argued that more conservative practices might have affected the outcome; however, the Big Five and other foreign lenders were also aggressively lending into the West (for which they also paid the price in loan losses). The fact that the CCB and Northland had to assume relatively high risks even to compete also suggests that the Western markets were not as neglected by lenders as the founders of CCB and Northland presumed.

It can be concluded, however, that regional institutions (at the very least in the West) are vulnerable to the cyclical nature of the resource based economy which tends to follow boom and bust cycles. The well publicized failures and mergers of other banks and trust companies in the West has clearly demonstrated that the problems in the West were not restricted to Northland and CCB.

Reliance upon the volatile wholesale money markets for funding also creates significant risk. Maintaining liquidity while dependent on the wholesale market can be very difficult in declining markets, and maintaining liquidity is as important as maintaining solvency. The nature of wholesale deposits is that they can be withdrawn quickly at the first sign of weakness. Withdrawals further reduce confidence which can cause additional withdrawals. The end result can be a run on deposits. Retail deposits are less volatile (in part because of deposit insurance) but the costs associated with raising these deposits are relatively high.

It is more difficult to conclude what might have worked in Western Canada. Northland management was attempting to gradually convert the Bank into a merchant bank. The essential nature of merchant banking is that there is a higher return for higher risk. History has shown that the higher risk exists. An institution has to be able to survive the boom/bust cycles in order to reap the high returns (which may be more readily achievable during the down cycles when there is less competition). Opportunity may well exist for well capitalized merchant banks in Western Canada. The additional returns inherent in successful merchant banking may be available to offset the inherently greater risk of operating only in the West and the higher costs of maintaining higher capital/asset ratios (a strong partner or parent corporation is an alternative to increased capital margins).

Options

The financial condition of the Bank was precarious in 1983. As concluded by Estey, the Bank would have failed conventional tests of solvency. By the time Bank management realized how bad the situation really was, there were only two options: declare insolvency or embark upon the path ultimately chosen in the hope that the economy would rebound and the Bank would be restored to health. The belief that prevailed was that if enough time could be obtained and confidence maintained, the bank would survive and the shareholders and investors would be rewarded.

Estey is critical of managagement because it did not seek a merger partner in 1982-1983. He states that "The prospect of a worthwhile merger was much greater in 1982-83 than by 1985.". (1) While it is true that the prospects would have been better in those earlier years, by the time senior managagement truly understood the nature and extent of the problems, the Bank had little to offer to a merger partner.

It was only in 1983 that Fortier was promoted to Senior Vice-President and Neapole joined the Bank. Prior to that time the Bank was still operating under the structure of delegation to the branches for both lending and collections and the extent of the problems with the loan portfolio were not known. Prior to 1983, Bank management did not have a clear understanding of the true condition of the Bank; much less did they understand that they should have been seeking a merger partner at the time.

It is unfortunate that new investors were required to allow the implementation of the strategies for survival. In 1983 the existing shareholders had little to lose. Based on Estey's findings, it appears that the new investors were investing in a very weak institution and that this was not readily ascertainable. It is interesting to note that in September, 1982 a report was prepared by an outside consultant, R. Tourigny. His analysis consisted of an examination of the Bank's financial reports and discussions with industry analysts. His report, which was discounted by the Board and never acted upon, disclosed many of the problems subsequently confirmed by the Estey Inquiry. (2) Nevertheless, it is unlikely that the new investors understood the true condition of Northland and the existence of system tolerance.

Although a substantial amount of testimony heard by Estey focused on prudent Bank practice and conservative accounting methods, it cannot be denied that the banking system has modified the rules at times to "smooth out" income and losses. Until very recently, losses were taken on a five year floating average basis. Also, the special accounting treatment for the "basket of 32" loans which were troubled sovereign loans is another example of the flexibility that can be, and has been, applied by even the very conservative (in their own view) Big Five. Northland and Epicon management were of the view that they were no different from the other banks except that the problems were more severe so the workout strategies had to be correspondingly more aggressive.

It is the writer's opinion that senior management of Northland in 1983 genuinely believed that they could save the Bank and that it would not only survive but thrive in years to come. It was inconceivable to management that the Bank would not at least survive. There had not been a bank failure in Canada since 1923. The fact that the Bank was ultimately expected to become a profitable niche lender may be a partial justification for accepting new shareholders' investment; they would have shared in the gains. This rationale would be of little consolation to debenture holders, however. They did not stand to gain from dramatic Bank improvement; they were only looking for a relatively risk-free investment (which yield reflected the supposed security of the investment).

A further indication of the commitment of management was the purchase of a significant number of shares of the Bank. While Estey is critical of the high amount of loans outstanding to management, a significant percentage of those loans were made to finance the purchase of Bank shares. The loans were on favorable terms which was consistent with the banking industry practice of offering preferred rates to management (which become "golden handcuffs"). Collectively, management would not have assumed the risk of borrowing to buy stock had they anticipated even a significant drop in the share price.

Workouts

Once the decision had been made to try to save the Bank, extraordinary measures were required. The Bank could not have been saved by conventional means. Therefore, the practices and policies implemented by Northland could not, and should not, be evaluated using conventional standards. Estey is critical of many of the workout strategies. Although he acknowledges that the conventional methods would not have saved the Bank, he applies conservative banking standards in his assessment of the workout strategies. Estey's comments with respect to Epicon Properties Inc. are a good example of the application of conservative standards to a workout strategy. Essentially, Estey views the entire Epicon involvement as a sham. The writer, who was involved in the formation of Epicon, respectfully submits that Estey was perhaps not fully informed as to the role of Epicon. Neither of the principles of the company were called to testify before the

Inquiry.

Estey concludes that the main, and perhaps sole, purpose for the creation of Epicon Properties, Inc was to improve the appearance of the Bank's financial statements through a revaluation of the assets and to reclassify a number of loans as productive on the basis of new appraisals done by Epicon. It cannot be denied that this was an important result of the formation of Epicon and that it was vital in helping maintain the appearance of profitability. The appraisals were generally done on a highest and best use basis assuming a reasonable recovery of the economy. The assumptions were always included in any assessment of properties. The methods and assumptions must have appeared to be reasonable or justifiable as the auditors and OIGB accepted the Epicon concept and approach to valuing the loans. It is important to note that accounting for Epicon was done on a consolidated basis with the Bank so there was no pure accounting advantage.

Estey seems to ignore the way that Epicon came to be created; it stemmed from the analysis and workout efforts of Ellesmere with respect to troubled Bank assets. Also, it was a necessary, but not sufficient, factor in the attempt to save the Bank. Admittedly, there is a strong argument that if measures such as the formation of Epicon had not been taken that the losses suffered by the investors and the anticipated losses of the CDIC and the Bank of Canada would have been smaller. Conversely, had the plans of management succeeded (which would have required the co-operation of the Western economy in staging a more rapid recovery than ultimately occurred) those same parties would have profited from the efforts of management. Irrespective of that argument, however, once the decision to try to salvage the Bank had been made, Epicon and the other workout strategies were essential for survival.

Northland pursued rapid growth for most of its relatively short existence. Especially during the Neapole years, the lending officers were given a strong mandate to increase the volumes. As is well established, the economy had been battered by the recession and the major banks and trust companies had virtually stopped lending. It required a great deal of effort (and creativity in many cases) to source new loans. As a result, there was little attention paid by the lending officers to weak or non-performing loans. Epicon managed these assets and added considerable value in certain instances and often stopped the erosion of value due to mismanagement or neglect.

Epicon was also instrumental in assisting Neapole and Fortier assess the overall problems. Directly and through SMART (which was managed by Epicon to a large extent), Epicon was instrumental in evaluating the existing portfolio, assessing loan officers in the branches, and sourcing new lending opportunities. By way of example, the writer was responsible for identifying the severe problems in the Vancouver region with both branch management and the loan portfolio.

As a result of the realization that simply working the problem real estate was insufficient, the Bank and Epicon sought ways to dispose of the assets while minimizing losses so that attention could be focused on merchant banking activities. Estey is critical of the one hundred percent loans that were made, but these were made to dispose of problem real estate. Typically, the loan was for the book value rather than the market value. The strategy was that the purchaser ended up with an asset for little or no risk but there was no profit in the transaction unless the value of the property could be increased to an amount greater than the debt. The strategy was that by making these types of loans to corporations or individuals who where qualified to make the changes necessary to add value to the land, the Bank was better off than disposing of the properties on a fire sale basis. Again, the strategy should not be evaluated by conventional banking standards.

The search for larger, and more permanent solutions to the problems led to transactions such as the Rondix sale. These were fairly drastic measures but which provided permanent solutions to a large blocks of the Bank's non-productive assets. The cost associated with these transactions were considerable, but senior management felt that if these loans could be disposed of, costs could be significantly reduced and the Bank could then pursue new lending opportunities. The new lending was anticipated to be much more along merchant banking lines which would result in a larger spread and higher fees, both of which would be required to offset the costs of disposing of the non-productive assets. The problems might have been too great to overcome, but the attitude was that the Bank had little to lose. Merchant banking might have been the only way to have save the Bank short of liquidation.

System Tolerance

The fact that the Bank was in very poor condition in 1983 is perhaps less surprising than the fact that the auditors and the Office of the Inspector General of Banking permitted the Bank to continue operating until September 1, 1985. It is the writer's opinion that Northland management genuinely believed that the auditors and regulators (through the OIGB) understood the approach being utilized by the Bank. While it is also clear that management did not make a great effort to enlighten the auditors and regulators as to the specifics of the transactions, the fact of the workouts, the future value appraisals and the accounting changes were well known to the both groups.

The local auditors did not have any bank audit experience. It must have been very difficult for them to assess whether the methods employed by Northland were in accordance with Canadian banking conventions. The auditors apparently relied primarily on management and as shown above, the OIGB relied on the auditors. System tolerance might be more accurately described as system failure.

When the system tolerance expired at the end of August, 1985, it came as a shock to management. As recently as July, 1985, they had received assurances from the Bank of Canada that it would continue to provide funding support and it would even permit the Bank to grow as this was a necessary part of the survival strategy of the Bank. Admittedly, there had been some heated discussions during July, but Northland management had been satisfied with the outcome. Also, the attention of the press had subsided considerably over the course of the summer after the articles about the "run" on the Bank.

If the CCB bailout had not been necessary in March, 1985, in all probability system tolerance (or system failure) would have permitted Northland additional time to try to solve its difficulties. In retrospect, with the drop in energy prices of early 1986, the end result would likely have been the same but the ultimate cause of the withdrawal of support by the Bank of Canada would have been different. Also, in the absence of the CCB failure the probability of a bailout of Northland would probably have been much higher. Prior to the failure of the salvage attempt, the confidence in the system had been preserved through quiet mergers or takeovers and the government had showed its desire to preserve the integrity of, and confidence in, the system by hastily arranging the ill-fated rescue attempt of the CCB.

The government was not prepared to guarantee the deposits of the Bank or provide another institution with sufficient guarantees, incentives or concessions to cause a merger or takeover, yet it ended up guaranteeing all of the deposits and disposing of the assets on a liquidation basis. There is little doubt that this was the most costly means of winding up the Bank. No value associated with a going concern was preserved and the assets were disposed of on a fire sale basis. Management of the Bank offered the government the option of an orderly wind-down (with new management, if necessary) but the government was not interested in considering this alternative.

The ultimate cost of liquidating Northland Bank would have been significantly less had Northland been merged with another insitution and the assets disposed of in the normal course of business for that institution. This would have required government guarantees but the risk assumed by the government would have been lower than through the use of Touche Ross Limited. The ultimate result was a bureacracy of chartered accountants (with limited banking experience) imposed on the remaining Bank structure with decisions required to be further ratified by the CDIC and the Bank of Canada and with each transaction requiring the approval of the court.

The Green Paper on Banking

In the final analysis one is left with the question as to why the major banks did not step in to preserve confidence in the Canadian banking system. Admittedly, the combined assets of Northland and CCB amounted to less than one percent of the market, yet in the past the banks had been quick to maintain system integrity. One possible explanation is that around the time of the bailout of the CCB, the government had introduced a Green Paper on banking.

The Green Paper proposed increased competition in banking and represented a real threat to the oligopoly of the Big Six. Perhaps the best way to stop the proposed legislation was to do nothing when the CCB and Northland were on the brink of failure. The large banks may have felt that the erosion in confidence caused by the failures would be less costly in the long run than increased competition. This would have been a perfectly rational decision. It is interesting to note that when the failure of CCB and Northland threatened the Bank of British Columbia, Mercantile Bank and Continental Bank mergers or takeovers were hastily arranged. The point had already been made and the effect of the failures of CCB and Northland may have been drastically underestimated.

As defined by O'Neill, "Strategy is a match between the organization's capabilities and its environment.". (3) Unfortunately for Northland, over its brief history, it lacked the capabilities necessary to implement the strategies required to survive. Both management and structure proved to be inadequate in coping with the economic environment of Western Canada.

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25. Willson, op. cit.
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28. Ibid.
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2. Estey, op. cit., 538.
3. Willson, op. cit.
4. Ibid.
5. Ibid.
6. Ibid.
7. Johnson, op. cit., 17.
8. Ibid., 36.
9. Ibid., 137.
10. Ibid., 74.
11. Ibid., 74-75.
12. Ibid., 103.
13. Estey, op. cit., 537.
14. Willson, op. cit.
15. 1977 Northland Bank Annual Report, 2.
16. Ibid.
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19. Estey, op. cit., 538.
20. 1980 Northland Bank Annual Report, Johnson, op. cit., 103.
21. Estey, op. cit., 538.
22. Willson, op. cit.
23. Ibid.
24. Ibid.
25. Estey, op. cit. 538.
26. Ibid., 538 & 182.
27. Ibid., 182.
28. Ibid., 538.
29. Ibid.
30. Confidential interview with a former Northland officer conducted by the writer.
31. Ibid.
32. Willson, op. cit.
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34. Ibid.
35. Ibid.
36. 1979 Northland Bank Annual Report, 13.
37. 1978 Northland Bank Annual Report, 20.
38. Estey, op. cit., 182.
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Chapter Three

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2. Ibid., 182.
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16. 1980 Northland Bank Annual Report, 7.
17. Ibid., 4.
18. Willson, op. cit.
19. 1980 Northland Bank Annual Report, 1.
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21. 1980 Northland Bank Annual Report, 4.
22. Ibid., 13.
23. Ibid., 13 & 17.
24. Ibid., 17.
25. 1981 Northland Bank Annual Report, 7-8.

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1. Estey, op. cit., 540.
2. Ironically, due to financial difficulties of its own, the Mercantile Bank was merged with National Bank of Canada in 1986.
3. Estey, op. cit., 40.
4. Ibid.
5. Confidential interview with a former officer of Northland Bank conducted by the writer.
6. Estey, op. cit., 540.

7. Ibid., 540-541.
8. Willson, op. cit.
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10. Ibid.
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13. Prisco had similar chairs while at Mercantile, they now occupy the office of a Vice-President of National Bank of Canada in Toronto.
14. Willson, op. cit.
15. Ibid.
16. Fortier, Martin, Personal interview conducted by the writer.
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19. Ibid., 3-11.
20. Ibid., 7-8.
21. Ibid., 9.
22. Based on the writer's personal knowledge and experience while employed by Northland Bank and related entities.
23. Ibid.
24. 1981 Northland Bank Annual Report, 4.
25. Ibid.
26. Ibid., 9.
27. Ibid., 10.
28. Ibid.
29. Estey, op. cit., 540.
30. Ibid., 542.
31. Johnson, op. cit., 223.
32. Willson, op. cit.
33. Ibid.
34. Ibid.
35. Estey, op. cit., 542.
36. Willson, op. cit.
37. Estey, op. cit., 184.
38. Fortier, op. cit.
39. Ibid.
40. Estey, op. cit., 541.
41. Ibid., 184.
42. Willson, op. cit.
43. Ibid.
44. Ibid.
45. 1982 Northland Bank Annual Report, 2.
46. Ibid., 3.
47. Ibid., 3, Willson, op. cit.
48. Estey, op. cit., 543.
49. 1982 Northland Bank Annual Report, 7.

50. Ibid., 4.
51. Ibid.
52. Ibid.

Chapter Five

1. WIllson, op. cit.
2. Ibid.
3. Ibid.
4. Estey, 184 and the writer's personal experience.
5. Based on the writer's personal experience.
6. Ibid.
7. Ibid.
8. Ibid.
9. Fortier, op. cit.
10. Ibid.
11. Confidential interview, op. cit.
12. Ibid.

Chapter Six

1. Based on the writer's personal experience.
2. Estey, 186.
3. Willson, op. cit.
4. Estey, op. cit. 189.
5. Ibid.
6. Confidential interview, op. cit.
7. Ibid.
8. Estey, op. cit., 610-611.
9. Ibid.
10. SMART meetings attended by the writer, 1984.
11. Ibid.

Chapter Seven

1. Estey, op. cit., 185.
2. As a member of SMART, the writer was privy to all internal reporting from the branches to head office. Also, the writer was assigned to assess the Vancouver portfolio and became involved in the assessment of staff and management.
3. Ibid.
4. Ibid.
5. A former officer advised the writer that near the end of the Bank's existence it advertised for a senior credit officer position requesting only 7 years of

experience.

6. Tenant activities had included butchering a moose in a living room of an apartment.
7. The loan amount was greater than 50% of the capital of the Bank in 1979.
8. Based on meetings and discussions with lawyers and consultants to Northland.
9. The writer was peripherally involved with the project.
10. The writer was personally involved in developing the concept and forming Epicon Properties, Inc.
11. Ibid.
12. The writer was personally involved with this transaction. In fact, it was because of the formation of Epicon properties and the magnitude of the challenge that this thesis came to be written. In the absence of the joint venture, the writer would not have worked full-time during his second year and would have not chosen the thesis option.
13. Estey, op. cit., 554.
14. The writer has recently encountered these guidelines in connection with some assets of a Canadian Bank located in the United States.
15. The writer was one of the original members of SMART.
16. The estimate appears to have been an industry rule-of-thumb and not the result of any research.
17. 1984 Northland Annual Report, 7.
18. Ibid., 6.

Chapter Eight

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9. Canadian Bond Rating Service, 1984 - Canadian Banks Statistical Review (CBRS Inc.: Montreal, 1985), 11 & 15.
10. Ibid.
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12. 1983 Northland Bank Annual Report, 6.
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17. Ibid., 8.
18. Ibid., 6-8.
19. Ibid., 48.
20. Ibid., 51.
21. Ibid., 50-61.
22. Ibid., 58-59.
23. Ibid., 59.
24. Canadian, op. cit., 11 & 15.
26. Ibid.
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30. Ibid.
31. Estey, op. cit., 230-231.
32. 1984 Northland Bank Annual Report, 6.
33. Ibid., 50.
34. Ibid.
35. Ibid.
36. Ibid., 6-7.
37. Ibid., 11.

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7. Ibid., 188.
8. Ibid., 192.
9. Ibid.
10. Ibid., 194.
11. Ibid., 192.
12. Ibid.
13. Ibid.
14. Ibid., 554.
15. Ibid.
16. Ibid., 199.

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1. Estey, op. cit., 551.
2. The Edmonton Journal, July 17, 1985, A14.
3. 1985 Northland Bank Third Quarter Interim Report

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5. Ibid., 6.
6. Confidential interview, op. cit.
7. Estey, op. cit., 212.
8. Ibid.
9. The Toronto Star, July 17, 1985.
10. Estey, op. cit., 549.
11. 1985 Northland Bank Third Quarter Interim Report.
12. Estey, op. cit., 549.
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14. Ibid.
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25. Ibid., 217.

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4. Press Release of the Department of Finance, September 30, 1985.
5. Globe & Mail, October 1, 1985, B1.
6. The Calgary Herald, October 2, 1985.
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2. Ibid., 225.
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6. Ibid.
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8. Ibid., 232.
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Appendix I

BANK OF CANADA — **BANQUE DU CANADA**

press statement — **communiqué**

For Immediate release Ottawa, September 1, 1985.

The Governor of the Bank of Canada, Mr. Gerald K. Bouey, said today that he has received notification from the Inspector General of Banks that the Canadian Commercial Bank and the Northland Bank can no longer be considered viable operations. The Bank of Canada has therefore concluded that there is no longer a basis for further liquidity support to these two banks and accordingly is ceasing immediately to provide advances to them. The Bank of Canada has been providing considerable liquidity to both banks in the form of fully secured advances; as of August 30th the advances outstanding to the Canadian Commercial Bank amounted to $1,316 million and advances outstanding to the Northland Bank amounted to $510 million.

The Governor stated that the difficulties experienced by these two banks do not reflect on the soundness of the rest of the Canadian banking system. He also reiterated that the Bank of Canada stands ready as always to provide liquidity if requested for any Canadian bank.

Appendix II

Summary of Results

Appendix IIa

NORTHLAND BANK

GROWTH OF ASSETS
(000,000'S)

YEAR	ASSETS
1977	$ 46.2
1978	103.9
1979	154.8
1980	253.9
1981	515.8
1982	653.3
1983	742.2
1984	1,080.7
1985*	1,354.3

* As at July 31, 1985

Source: Northland Bank Annual Reports 1977-1984 and Northland Bank 3rd Quarter Interim Report for Nine Months Ended July 31, 1985.

NORTHLAND BANK

NET INCOME
(Before appropriation for losses)
(000'S)

YEAR	INCOME
1976	$ 6
1977	35
1978	380
1979	491
1980	1283
1981	4371
1982	1830
1983	2945
1984	3347
1985*	2852**

* As at July 31, 1985
**Annualized

Source: Northland Bank Annual Reports 1977-1984 and Northland Bank 3rd Quarter Interim Report for Nine Months Ended July 31, 1985.

Appendix IIc

NORTHLAND BANK

LOAN LOSS EXPERIENCE
(000'S)

YEAR	LOSS
1978	$ 35
1979	436
1980	294
1981	1720
1982	2776
1983	4491
1984	4021
1985	N/A

Source: Northland Bank Annual Reports 1977-1984 and Northland Bank 3rd Quarter Interim Report for Nine Months Ended July 31, 1985.

Appendix IId

NORTHLAND BANK

GROWTH OF THE LOAN PORTFOLIO
(000'S)

YEAR	LOANS
1977	$ 26,476
1978	80,741
1979	128,882
1980	213,803
1981	400,790
1982	531,473
1983	622,618
1984	945,784
1985*	1,184,900

*August 31, 1985

Source: Northland Bank Annual Reports, 1982 & 1984, and Operations Memorandum by the Curator Northland Bank October 31, 1985.

Appendix IIe

NORTHLAND BANK

CAPITAL
(000,000'S)

YEAR	CAPITAL
1976	$10.2
1977	10.3
1978	10.7
1979	10.9
1980	20.4
1981	23.4
1982	31.2
1983	31.4
1984	57.1
1985	58.3

* As at July 31, 1985

Source: Northland Bank Annual Reports 1977-1984 and Northland Bank 3rd Quarter Interim Report for Nine Months Ended July 31, 1985.

Appendix IIf

NORTHLAND BANK

EARNINGS PER SHARE
(Fully diluted, after tax)

YEAR	EARNINGS
1976	$ .01
1977	.03
1978	.44
1979	.57
1980	1.31
1981	2.14
1982	.83
1983	1.27
1984	.59
1985*	.44**

* As at July 31, 1985
**Annualized

Source: Northland Bank Annual Reports 1977-1984 and Northland Bank 3rd Quarter Interim Report for Nine Months Ended July 31, 1985.

Appendix IIg

NORTHLAND BANK

NON-PERFORMING LOANS
(000,000'S)

YEAR	LOAN AMOUNT
1980	$ 5.0
1981	10.6
1982	44.7
1983	99.0
1984	75.2
1985*	43.4

* As at July 31, 1985

Source: Northland Bank Annual Reports 1980-1984 and Northland Bank 3rd Quarter Interim Report for Nine Months Ended July 31, 1985.

Appendix IIh

NORTHLAND BANK

PROVISIONS FOR LOAN LOSSES
(000'S)

YEAR	PROVISION
1978	$ 11
1979	118
1980	153
1981	1258
1982	2231
1983	3292
1984	4586
1985*	4841

* As at July 31, 1985

Source: Northland Bank Annual Reports 1977-1984 and Northland Bank 3rd Quarter Interim Report for Nine Months Ended July 31, 1975.

Appendix IIi

NORTHLAND BANK

RETURN ON COMMON SHAREHOLDER'S EQUITY

YEAR	PERCENTAGE RETURN
1980	9.40
1981	16.79
1982	4.90
1983	7.57
1984	5.60
1985*	1.60

*As at July 31, 1985

Source: 1984 Northland Bank Annual Report and Northland Bank 3rd Quarter Interim Report for Nine Months Ended July 31st, 1985.

Appendix IIj

NORTHLAND BANK

RETURN ON AVERAGE ASSETS

YEAR	PERCENTAGE RETURN
1980	.62
1981	1.14
1982	.31
1983	.42
1984	.37

Source: 1984 Northland Bank Annual Report

Appendix IIk

NORTHLAND BANK

GEOGRAPHIC DISTRIBUTION OF LOANS
(Percentage of total loans)

Location	1982	1983	1984
British Columbia	24.7	24.8	18.0
Alberta	56.9	53.3	58.0
Saskatchewan	1.4	3.5	4.0
Manitoba	8.4	9.9	7.0
Ontario	0.0	0.0	5.0
International	8.6	8.5	8.0
	100.0	100.0	100.0

Source: Northland Bank Annual Reports 1983-1984

Appendix III

Press release of the Department of Finance issued March 25, 1985:

"Support Package to Ensure Viability of Canadian Commercial Bank"

The Honourable Barbara McDougall, Minister of State (Finance), announced today that a joint agreement has been reached to ensure the long term viability of the Canadian Commercial Bank. Parties to the agreement, which involves an infusion of capital with repayment provisions, include the Province of Alberta, six Canadian chartered banks, Canada Deposit Insurance Corporation and the Government of Canada.

The support Package is designed to provide the Canadian Commercial Bank with sufficient funds to ensure solvency following a recent and sharp deterioration in its U.S. loan portfolio.

The agreement will result in the purchase by the support group of nonperforming loans. This transaction will leave the bank in a strong position of solvency in order to support its deposit base.

Representatives of the Canadian Commercial Bank notified the Office of the Inspector General of Banks on March 14, 1985, that the deterioration in its loan portfolio could place the bank in a position whereby it could be unable to meet its obligations to depositors and creditors.

Following analysis of the Candian Commercial Bank's position, the Inspector General of Banks determined that an infusion of additional funds in the amount of $255 million would ensure that the bank could continue to play a key role in the Western Canadian economy.

A restructuring package initiated by the Canadian Commercial Bank was negotiated by the Inspector General of Banks with the parties to the agreement.

The CDIC, which is funded by member deposit-taking institutions, will provide $75 million. The remaining $180 million will be shared equally by the Province of Alberta, the banking group and the Government of Canada in the amount of $60 million each.

The repayment program calls for the Canadian Commercial Bank to pay 50 percent of its future pre-tax profits to the participating institutions until the capital is repaid in full. The remaining 50 per cent will be retained by the bank. No common or preferred share dividends will be paid until the repayment program is complete. As part of the transaction, members of the support group will be entitled to receive warrants and payment of principal and interest on subordinated debt will be postponed.

In a separate arrangement, the governments of Alberta, British Columbia, and Canada will be purchasing up to $39 million of the subordinated debt.

"I have full confidence that this cooperative Support Package involving Canada's largest chartered banks and the two Governments will permit the Canadian Commercial Bank to continue its active and important role in the growing economy of Western Canada", said Minister of State (Finance) Barbara McDougall. "I have in addition been assured by Governor Gerald Bouey that as usual the Bank of Canada stands ready to provide liquidity for Canadian Commercial Bank, if requested, as well as for any other Canadian bank."

The Minister concluded, "This Support Package represents a strong collective vote of confidence in the health of the economy of Western Canada."